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P R O C E E D I N G S
of the
PUBLIC OVERSIGHT BOARD
SEC PRACTICE SECTION - AICPA
PUBLIC HEARING ON SCOPE OF SERVICES BY CPA FIRMS

August 17 and 18, 1978
Hyatt Regency O'Hare
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THURSDAY MORNING SESSION

August 17, 1978

The Public Oversight Board Public Hearing on Scope of Services by CPA Firms, SEC Practice Section, American Institute of Certified Public Accountants convened at 9:00 o'clock in the United-B Room of the Hyatt Regency Hotel, Chicago, Illinois, with Mr. John J. McCloy, Chairman, presiding.

MR. JOHN J. McCLOY: Ladies and Gentlemen: We have a rather long schedule this morning, and I am terribly anxious to keep up with it so we don't get behind and we can give an opportunity to everybody that wants to be heard, to be heard.

Sitting before you here are the Public Oversight Board of the AICPA SEC Practice Section. I think that is the dignified title, and this Board has the imposing task of overseeing the operations of the self-regulatory program of the AICPA to help insure its thoroughness and its fairness and its efficient operation when it is in place and functioning.

As I see our role, it was not one having line authority to make decisions or act in any sort of way as a reviewing body in regard to the action of the profession in the course of its self-regulatory functions, but we are charged and very pointedly charged, I think, with the duty of observing the operation of the system and reporting to appropriate bodies as to our thoughts and recommendations arising from that observation. We have been asked to render our judgments on proposals now being put forward to limit, at least to some degree, the scope of the management advisory services which the accounting firms should engage in at the same time they are called upon to attest the fairness of the financial information of the client.

The proposals arise out of the very strong desire that those responsible for the conduct of audits of

companies should maintain a fully objective and independent attitude, in regard to their relationships with those companies who employ them so that all who rely on those statements may have the confidence that the auditors' findings and attitudes embody that independence and that objectivity.

We are aware that this subject of the so-called "MAS" (management advisory services) is not a new one. Much already has been written about it and said about it, and having been given the duty of taking a look at the background, I am practically blind from having tried to read and keep up with what has appeared. We felt that before we were in a position where we could render a judgment in regard to this, we might make provision for a hearing as there were a number of interested groups who did indicate that they would like to have their thoughts brought at least up-to-date. It became apparent that this was a desirable thing to do even though so much ink had been spilt heretofore on this subject. We are aware that there are many varied views.

I have asked Mr. Ray Garrett, Jr., Vice Chairman of our Board, a former Chairman of the SEC, and a partner in the law firm of Gardner, Carton and Douglas, to take the laboring oar in preparing for these hearings and preparing us for the position that we now occupy in sitting in judgment as to some of the recommendations in respect to this subject.

I think I ought to say that we are quite aware of the fact that this subject is one in which very significant and substantial interests are involved.

I don't contemplate that we will be in a position to render any opinions, so to speak, from the bench today on it. I think I ought to also warn you that our decisions aren't decisive, though I dare say they may be influential. It is quite possible, as I see it at least, that some of the judgments of the Board we may

want to defer until the Board observing the self-regulatory procedures has gained more experience before we conclude what our final judgments are on the whole subject.

I am now going to turn the conduct of this hearing over to Mr. Garrett as he and his firm, as I say, have pulled the laboring oar in the preparatory work for it, and in many other respects he is better qualified and equipped than I am to assume this task.

But before I do that, I would like to introduce to you the members of the Board. I will start with Professor William L. Cary who is on my left. He is Professor at the Columbia Law School, and a former Chairman of the SEC.

I might say that Mr. John Harper, another Board member, couldn't be with us today because he recently came on the Board, and his appointments had jelled, as had ours. He is a former Chief Executive Officer and Chairman, as you may know, of ALCOA.

Mr. Arthur Wood, on my right, is former Chairman and Chief Executive Officer of Sears Roebuck & Co.

I have mentioned Mr. Garrett. Mr. Charles Manzoni is from Mr. Garrett's firm.

He and Mr. Richard Stark is on the right of Mr. Wood. He is a member of my firm, Milbank, Tweed, Hadley & McCloy, and he has been looking over and supervising the legal work which we have had to assume in large part in connection with the organization of the POB.

Mr. Matusiak is a former partner of Alexander Grant & Company, and he is the Executive Director of the POB.

I think I have introduced everybody. I have referred to Mr. Garrett. I am going to turn the proceedings over to him and let him conduct this hearing throughout.

I hope we will have a chance to really get your views. In the first place we shall be glad to have your statements and then we can perhaps have some questions

afterwards, all for the purpose and all for the objective of trying to educate us, as well as you perhaps, as to some of the problems that we face in trying to make our recommendations on this subject.

Mr. Garrett, will you take over.

MR. RAY GARRETT, JR.: Thank you very much, Mr. McCloy.

I imagine that most of you have participated in sessions similar to this, but in case you have not, I should emphasize it is not a trial. Nobody is here by compulsion or under oath, so we hope you tell us the truth.

We are grateful to you rather than being in any accusatory or judgment sense. We very much want education, and the benefit of as many views from as many directions as we can get because we know that to the extent that our conclusions and recommendations are influential, this particular issue, or set of issues, probably has a more immediate and deeper effect on the financial welfare of more accountants than any of the other issues that we are dealing with in the self-regulatory program.

This sort of thing can put people out of business. We know that, and we don't want to participate in recommending anything that has that kind of effect upon people without understanding as best we possibly can what we are recommending and why.

So we are grateful to you, both for the written comments that you and your associate firms have supplied, and also for the willingness to take the trouble to come here and actually talk to us.

We do have a court reporter present making a record, a transcript, for our own benefit. We also have before us, each of us on the panel, the written materials that have been submitted, but in giving your statements, I think probably the wise thing is not to assume that we

have all read them all.

I dare say at this point there are varying degrees of diligence and time available and some of the written statements just, in fact, arrived this morning.

As to your own presentations, we have allowed a half hour apiece. We will have, incidentally, a coffee break from 10:15 to 10:30. The half hour is yours, but if it is all consumed in reading a prepared paper, it will suffer from our point of view from lack of any opportunity to ask any clarifying questions, but that is up to the individual persons who are making statements as to the extent to which they want to read a prepared paper or summarize or present their views in any fashion that is suitable to them.

As I say once more, the setting is somewhat more formidable than I think we had anticipated, but this is a friendly educational session and not a court, and not a place in which anybody is intended to get hurt in any fashion.

We will begin--I don't know whether copies of this schedule have been made available, Lou, to anybody else. Have they?

MR. LOUIS W. MATUSIAK: Yes, they have.

MR. GARRETT: Good. That will make it easier.

The first persons to make statements are George Catlett and Bill Mueller from Arthur Andersen & Co.

I would appreciate it very much if we could get started, George and Bill.

MR. GEORGE R. CATLETT: I am George R. Catlett, a senior partner of Arthur Andersen & Co., and I am accompanied by William J. Mueller, Vice Chairman of our firm with responsibility of our administrative services practice.

My written statement has been submitted to you in advance of this hearing, and I will summarize a few of the matters covered by that statement.

When society grants to accounting firms the authority to give reports on financial statements for use by the public, certain responsibilities go with that authority. These responsibilities include engaging only in those activities that do not detract in any significant way from the attest function.

There have been controversy and confusion about the need for restrictions on the services of accounting firms. Unless the underlying reasons are analyzed and applied in a sensible and logical manner, no useful purpose will have been served for investors, for the business community, for the accounting profession, or for anyone else.

In considering the limitations on the scope of services of accounting firms, I believe that two basic criteria are involved: independence and compatibility. All other criteria represent guidelines for the implementation of these basic criteria.

Independence is a cornerstone of the attest function. General agreement exists on the general proposition that accounting firms should not engage in activities that compromise or adversely reflect on the attest function in a manner that would impair or appear to impair the independence of the auditors in giving reports on financial statements.

The divergence of views with respect to independence does not result from the general concept involved but from questions concerning how the concept

should be applied.

Some agreement exists on the general proposition that accounting firms should perform only those services that are compatible with their responsibilities to the public. The credibility of independent auditors which is so necessary in carrying out their function in our American system depends upon a clear demonstration that CPAs, independent of clients and government alike, serve the public interest and perform a vital role in our system better than any other arrangement.

If an accounting firm were to appear to be like a department store, constantly adding diverse and unrelated lines, an adverse image of such a firm could be created. The attest function could appear to be downgraded, at least in the eyes of persons outside the accounting profession, whether or not independence is really affected. This is illustrated by the fact that certain services, such as plant layout and design which are currently under some criticism, are only remotely related, if at all, to independence.

The divergence of views with respect to how a compatibility criterion should be applied is greater than with respect to independence, because the accounting profession has recognized the independence issue for a much longer time and has had more experience in dealing with it.

The principal guideline in the proposed amendment relating to the compatibility criterion is the restriction of "accounting and auditing related skills" which replaces the existing guideline of "accounting and financial related areas." This is a substantive change. While "skills" may have some merit as a guideline, "areas" would give more understandable, and probably more desirable, guidance in the long run. The "skills" presumably could be used in any area even though such area is not related to accounting, financial or auditing.

The application of the criteria only to services performed for SEC reporting companies was added to the original membership requirements of the SEC Practice Section by specific vote of the AICPA's Council because of the emphasis on publicly owned companies and because of the concerns of smaller accounting firms about possible limitations on their services for privately owned companies. Smaller firms have had a continuing question about whether rules adopted in this context eventually would adversely affect their practice. Undue restrictions should not be placed on these firms in serving privately owned companies. The fact that there are two sections in the AICPA Division for Firms represents recognition of the different characteristics of the nature of public accounting as it related to companies under the jurisdiction of the SEC and to privately owned companies.

Auditors who elect to audit publicly owned companies should be affected more by "public interest" and "investor interest." Such auditors assume a relatively greater burden in maintaining credibility in the eyes of investors and other interested parties, particularly insofar as the compatibility criterion is concerned. The same general rules with respect to independence should apply to all auditors. However, a greater burden in this regard may fall on the auditors of publicly owned companies.

A question exists, particularly for the larger accounting firms with many publicly owned clients, concerning the desirability of offering certain services to privately owned audit clients and to nonaudit clients but not to publicly owned audit clients. Such a distinction between audit and nonaudit clients can be made under the independence criterion, but it is more difficult to do so under the compatibility criterion.

I see no impelling reason to change the traditional work of either large or small accounting firms for independence or compatibility reasons in the areas of (1) taxes and (2) the design and installation of accounting systems and the performance of studies related to accounting, general record keeping and control. Other services in accounting and financial related areas may also be acceptable. However, there will be some services such as those discussed in the proposed appendix that should be reviewed and considered periodically.

The Executive Committee of the SEC Practice Section plans to review the entire record of this public hearing and consider the views of the Public Oversight Board. I am confident that the Executive Committee can and will make improvements in the proposed amendments so that the objectives we are all seeking can be achieved and the public interest can be served.

Thank you for the opportunity of appearing at this hearing.

MR. CATLETT: Bill and I will be glad to answer any questions you may have.

MR. GARRETT: Thank you, George.

We will start with the Board members first. Have any of you questions that you would like to put?

PROFESSOR WILLIAM L. CARY: I would like to ask a number of questions. One, of course, is not related to your firm, George, and therefore perhaps not quite proper to ask you, and yet one of the issues that is before us is this matter of the actuarial services.

Obviously, your firm does not perform them. Is this a matter of principle, or do you have a view as to how that should be handled by other firms?

MR. CATLETT: I think the actuarial area is one that should be given careful consideration by your Board and by the Executive Committee. It is an area that has had much discussion in Washington, as you know, along

with a few other areas.

I would like to answer your question by making a few comments about it. I will try to relate it to some of the statements that I have just made.

I think actuarial work is in an accounting and financial area, as we think of the various criteria. I don't think there is much argument about that.

It is a skill that could be used on audits of certain companies, but I do not believe that it is a skill that is necessary for accounting firms to have. One evidence of this is that most accounting firms do not have actuarial skill.

You certainly can't say that it is necessary to have such skills to make adequate audits, although it is a skill that could be used if you did have it.

One of the questions that is raised in this area is whether, when there is actuarial work and audit work in the same firm, the actuarial arm of the firm is playing a major role in determining amounts that are in financial statements which the auditors, on the other hand, end up auditing as part of the financial statements.

One of the questions that is raised in this regard is whether the auditors would be as likely to question the methods and assumptions and various things going into the actuarial computations as they might if it was done by another firm.

I am not commenting on that. I am just saying these are the kinds of questions that come up.

There is also the question of how much participation there is by the client in the actuarial determinations. Of course, this leads into the independence question. Actuarial work is the work of a separate and distinct profession.

The point that arises sometimes when this is discussed is that some people argue that it is desirable and necessary to have the actuarial skill for the audit

function. The same thing could be said, I think, of geologists, appraisers, lawyers and a lot of other matters that relate to audits. In making audits, auditors rely to some extent on geologists in oil company audits, appraisers with respect to mergers, and of course, lawyers in various ways.

This is a subject that has been under discussion and needs careful consideration, and our firm does not do it. Some firms do do it. These are the things that need to be considered in deciding this question, and it is one that has to have careful consideration if for no other reason than it has been under question in Washington and other circles.

PROFESSOR CARY: May I ask one more question? It relates only peripherally to the preceding question. Bill Mueller can probably help us.

The MAS concept is so broad that each person has a different, I suppose, definition of it.

I take it that in your firm it is a fairly narrowly defined role. Does that correctly differentiate it, say, in your firm from other firms--some of the other firms?

MR. WILLIAM J. MUELLER: I am at a little disadvantage because I am really not that conversant with all of the nuances and the scopes of practice of the other firms. I can only speak for ourselves.

We internally do not really feel that our scope of practice is narrow. It involves primarily the design, development, implementation of control systems for management, and the accounting and operations areas of various enterprises, private and governmental. It also involves the studies related to these methods.

It keeps us all very, very busy hiring enough people to do the work that comes to us in these areas, and we have never really seriously considered going into some of the peripheral areas that other firms have gone

into.

There are some that we have looked at, and on a policy basis, decided that we didn't want to get into them. There are others we have looked at and decided we just didn't have the requisite expertise and because of this chose as a matter of business strategy not to get into them.

MR. GARRETT: When you say "on a policy basis," do you mean that they would not meet one of the two criteria that you have set forth; either they would not be compatible with the audit function or they would jeopardize your independence?

MR. MUELLER: That is correct.

MR. GARRETT: Could you name an example of one that you decided not to go into and on which of those grounds?

MR. MUELLER: Yes, I think I could. You know, it is an interesting question because I think we could say that executive recruiting does not meet our criteria. On the other hand, even if it had been acceptable, I think we would probably not have chosen to go into it for other reasons, but nevertheless, that is one area that does not meet our criteria.

MR. McCLOY: Are there any other ones that you can think of besides the "head hunting?"

MR. MUELLER: Nothing that we have seriously considered going into.

MR. GARRETT: I presume by executive recruiting, the emphasis is on the executive.

MR. MUELLER. That is right.

MR. GARRETT: You don't decline the help people find employees at a lower level than executives.

MR. MUELLER: As you know, we do attempt to help our own employees become placed when it is decided that they no longer have a future career with our firm or unilaterally decide that they do not want to be in

public accounting. We do advise them of openings that we are aware of in our client organizations.

We don't do this on what might be considered a professional basis. It is merely a clerical clearing-house type of operation. We make these names known to the clients, and also make it known to our people that there are openings with clients.

We certainly attempt not to imply firm endorsement, however, to the qualities or merits of these people when we make these types of referrals.

MR. CATLETT: I might make a couple of comments. One of the distinctions in, say, the recruiting area is that we have never done executive search in the sense of going out and searching out people and screening them and that sort of thing.

MR. McCLOY: You will respond to inquiries, though?

MR. CATLETT: That is right. Our extent of that has either been referring our own people or casual referrals. Somebody would say, "Do you know anybody?" We would say, "We know Tom Jones. You might talk to him."

But we have never gone out and written letters, placed ads and tried to find people and screen them.

MR. GARRETT: Organizationally, you do not have a department or branch for such services.

MR. CATLETT: No. One other area that we considered, I think it is fair to say, was when some of the firms acquired actuarial firms. When that came up, we considered whether or not we should go into that area, and we decided not to for various reasons.

MR. McCLOY: May I ask you one question. Do you do plant layouts?

MR. MUELLER: No, sir, we do not.

MR. ARTHUR M. WOOD: I would like to ask what percentage of your clients are privately owned?

MR. CATLETT: I presently don't have that

statistic in mind. I can tell how many are public.

MR. WOOD: It doesn't have to be accurate.

MR. CATLETT: We have between one thousand and eleven hundred companies under SEC jurisdiction, which would be in the publicly owned area. Of course, we have many thousands, many more small clients. In numbers, we have a lot more privately owned clients than we have publicly owned. We have many thousands of privately owned clients, whereas we have a thousand or eleven hundred companies under the SEC.

Of course, in volume of work, the proportions are different because the publicly owned companies tend to be much bigger engagements, but they are both important part of our practice. We don't in any way deemphasize or consider our privately owned clients to be second rate. We consider them just as important clients, and try to give them the same quality of service.

MR. MUELLER: I might be able to add something there, George. A look we did at this a little while ago would indicate that the number, from order of general magnitude, might be about ten thousand or eleven thousand in that area, in the privately owned.

MR. WOOD: Do you see any difference in the requirements of privately owned or small publicly owned clients for a broader range of advisory services?

MR. CATLETT: I might comment and Bill may add some, too.

I think the type of service you give is a little different because if it is a smaller company, you tend to give more of a continuing service and your relationships tend to be a little more personal, month to month, than large companies, and perhaps at times you tend to give more business advice and help them in various ways.

As far as our administrative services practice

is concerned, I don't think it is a whole lot different.

Bill, you might comment on that.

MR. MUELLER: No, there really isn't in principle a great deal of difference. I think perhaps some of the techniques that one uses in performing the services are somewhat different. Perhaps you are more of an educator working with a small business than you would be with a larger one. Perhaps you have to explain why you are doing what you are doing a little more clearly in some respects in a more basic manner than you would in a larger organization, but the results, the outputs of your services, tend to be the same.

MR. WOOD: We have had comments from a number of smaller auditing firms, and from a number of small businesses, clients of those firms, which indicate that a rather broad advisory service is vital to their success, and those seem to me to be rather compelling.

MR. MUELLER: If I could make a comment on that, I think that maybe you are talking, when you talk about the privately owned company, about a different kind of a client than when you are talking about a very small accounting firm serving the small privately owned company.

There are different degrees of smallness involved, so that maybe we are not talking about the same type of organization when we talk small as the smaller accounting firm is in all cases. Maybe we should characterize it as large, medium and small. When we refer to small, we are sometimes talking about the medium-sized company. When they are talking small, they are talking about a smaller entity that perhaps does need more day-to-day attention and different types of advice.

Also, this is a matter of firm organization to some extent, and this is why I would like George to also respond to this. It may well be in the very

small company that the accountant, the auditor, is the person who is rendering this type of, let's call it, informal MAS advice. In our organization, our group, we call it administrative services, is performing project type work with these clients, whereas the audit division is performing the day-to-day consulting type advice that the smaller practitioner refers to as MAS.

MR. CATLETT: I agree. I think it would be unfortunate if undue restrictions are put on accounting firms in working with small companies, particularly so long as it doesn't affect their independence in giving opinions on financial statements.

Another important point, too, is that when an accounting firm elects to go into the area of auditing publicly owned companies with public investors and the related public interest--and accounting firms don't have to do this and some firms, of course, don't have that type of auditing--such election to go into that practice, whether you have one or a thousand publicly owned clients, means that you are assuming an additional responsibility to the public. There is a larger public interest in such work than for a privately owned company. I think firms should be expected to have a higher level of public responsibility and consider the public interest more, and the effect on the public, which involves independence and compatibility and those kinds of things to a greater degree than in the case of the smaller, privately owned companies.

You can argue: What is the difference? To me there is a big difference. There is a big public interest difference in the case of a large publicly owned company, and I think the managements of those companies feel it as well.

MR. WOOD: You have stressed or have identified independence and compatibility of services as the two

principal criteria that you consider as affecting your attest function.

You then referred to the Executive Committee's proposed test that services use accounting and auditing-related skills. Who is going to decide whether a particular service requires the use of accounting-or auditing-related skills? Who is going to be the judge of that relationship?

MR. CATLETT: I suppose that insofar as the SEC Practice Section is concerned, the accounting firm itself would make the first judgment. Then if there was any question, it could come up in the peer review program and go through the Peer Review Committee up to the Executive Committee. The Executive Committee would then decide whether or not it agreed with the firm on that point. In your monitoring function you could also look at it, if there was a question and controversy, so in the end it would have to be a judgment matter by whoever is making it. Thus, it would be first the firm, secondly the Executive Committee, and thirdly your views from a monitoring standpoint. But, of course, any of these judgments would have to be a matter of opinion.

The test that is in the plan now is accounting and financial related areas. That is what was in the initial plan and that is being changed, at least by the proposed amendment. In either event, it is a judgmental matter, but as I pointed out, there is a difference, a significant difference, between accounting and financial related areas and accounting and auditing related skills. They are different kinds of tests, but both would require judgment.

MR. WOOD: That is all I have.

MR. GARRETT: You would prefer to areas termed as more closely meeting the concept of compatibility, I presume.

MR. CATLETT: I have thought about that a lot, and the Executive Committee debated this at great length before the plan was originally adopted. What is in the plan now, in the original document, is the accounting and financial related areas which I thought was the right way to go about it in the first place. I personally would prefer to stay there rather than to shift to the other one. I wouldn't say that skills is not a possible way to go about it and is not one that you could live with, but you understand I have a preference in the other direction.

The questions that arise in this area, such as in Washington, cause people to think in terms of areas.

The plant layout and all of those types of things relate to areas basically, and people tend to think in terms of areas. When you get into compatibility, they think about whether a particular area is compatible with the audit area. People think that way, and it is easier to understand, and easier to apply. In the long run, a test based on areas will be better for the accounting profession and everybody else.

The skills test is another approach. This test is the other way around. You need the skill on the audit. Therefore, it is all right to use it in other areas.

One problem, though, long-range, is that accounting and auditing related skills can be used in areas that have nothing to do with accounting and financial related areas. Then when you meet the test, but are clear out in left field, you will be subject to severe criticism.

MR. GARRETT: I understand your argument to be that if accounting and auditing related skills include anything that an auditor ought to be able to understand or would have some use for in conducting

an audit, that could go just about everywhere depending upon your clients.

MR. CATLETT: Including law.

MR. GARRETT: Yes, sure. We won't get into that, George. (Laughter) That war is a temporary truce. You could go into geology and engineering and all sorts of things.

MR. CATLETT: Not only that, but also even a skill about which there is not much argument, such as an accounting computer skill or something, such as that, there isn't much argument about, you could go outside the accounting and financial areas and use the skill for engineering or something like that which has nothing to do with accounting or financial at all.

MR. GARRETT: But why should there be a compatibility criterion, however we phrase it, if you have satisfied the independence need? I suppose we are going to find universal conceptual agreement, at least, on the independence question.

MR. CATLETT: You will find conceptual agreement; but you will find great disagreement about what constitutes it.

MR. GARRETT: I am certain we will.

MR. CATLETT: It has been my job in our firm to worry about our own policies in this area, and for the last ten or fifteen years I have struggled with it in our firm. We have been debating it for a year in the Institute, and of course, we have debated it even before that.

With all the commotion that there has been in Washington and in articles that have been written about this subject and questions that have been raised in the academic area, it has become obvious to me that there are two basic tests. Independence obviously is one test, but the perceptions of this problem, whether right or wrong, have caused questions to be raised

in a lot of places, including Washington. Outside the accounting profession, there is a concern, and I think I can say there is a serious concern, which is not frivolous, about the practice in some areas that has nothing to do with independence. This is a legitimate concern, and therefore it has to be in the area of image or compatibility or something like that. I like "compatibility" better than "image" as a word, but there has to be something there. Otherwise, you could be a veterinarian and a thousand other things. You could do almost anything that you could legally do. After all, if we were veterinarians, that wouldn't affect our independence on audits, but I am not so sure it would be a good idea from the viewpoint of the public.

MR. GARRETT: But you might come to that conclusion from a business point of view, mightn't you?

MR. CATLETT: Sure, but all I am saying is that the independence test alone would permit you to do thousands of things that are way out, that have absolutely nothing to do with independence on audits. It just seems to me, on the face of it, that this is not desirable. Therefore, there has to be some test on that side, and I use the word "compatibility" in searching for a word in that area. The conceptual aspect of this is that if society gives us the authority and right and responsibility to certify financial statements, on which the public is going to rely, they expect us to operate efficiently in that area and do things that are compatible with that, and they don't expect us to do a thousand other things at the same time. We would either downgrade what we are doing or, at least, downgrade what it looks like we are doing, and this could impair the attest function on which our whole business community relies.

One of the important things in our system is the reporting on financial statements by auditors and the reliance of the millions and millions of people on that.

In fact, the whole free enterprise system is somewhat dependent on it because it involves the credibility of financial reporting of business enterprises. It is such an important crucial function that you don't want to water it down with too many other unrelated things that are not accounting and financial related, even though they might not affect independence.

MR. McCLOY: Are you saying, in the case of public owned companies, the conduct of the accounting firm has to take into account appearances to a greater degree than privately owned companies?

MR. CATLETT: There is no question about that.

MR. McCLOY: Even though there is no causal connection between them.

MR. CATLETT: Some people say that if you are really independent, what difference does it make. But it makes a lot of difference, because if the public in this country on a broad basis ever decided and perceived that they no longer could rely on the certification of auditors, then not only would the accounting firms suffer but the whole business system would suffer. This is such an important link in our system that we have to zealously guard it and not let it be ruined by a bunch of irrelevant things.

Of course, I realize that when I say "compatibility," there is a lot of argument about what that means, too, but what I am trying to explain is the general idea. There are a lot of services that can be performed that are a great service to clients and are compatible and help society and help

the business community. But, not only would the accounting firms suffer, but every one would suffer, business in particular, if the financial statements issued by publicly owned companies in this country were such that the people getting them were not sure whether they could trust them or not. Business is going to be the first to suffer. That really brings on government regulation.

PROFESSOR CARY: I would just like to revert back to one other area to which you made reference, George, about large firms. I mean, that you have a higher public responsibility vis-a-vis the large firms than vis-a-vis the small ones.

Now, trying to analyze it, does that mean that criteria should differ between large and small firms? I am asking myself, try to think it through this way. It seems to be that small firms are still public firms in one sense or another because most of the companies that you would audit or anybody would audit would have a few outside shareholders.

MR. CATLETT: Or you might have bank loans.

PROFESSOR CARY: Right. I was going to say you have bank loans, creditors and then you have probably some outsiders, although you may not call them the public because it is not that broad.

With that in mind, it seems to me that as far as applying the criterion of independence is concerned, it is probably a policy matter. Looking at it from our standpoint, it may not be wise to have a different policy vis-a-vis the small than vis-a-vis the large firm for independence.

The appearance which you just referred to, maybe there is a difference because that is a public, but am I right in analyzing it that way?

MR. CATLETT: I think in general I would agree with that. I would have the same two criteria

as far as basic criteria are concerned. What I am talking about is the application of them.

I agree that in the independence area there would be less difference than in the compatibility area. Basically, there shouldn't be a difference in the independence area, if you are certifying financial statements. But even there, there is a zone in the application where maybe you lean over backwards to be more pure in auditing a big publicly owned company than you might in the case of a privately owned company just because there is a big public interest. There is more concern in Washington at the SEC and everywhere else about publicly owned companies.

It's a small zone of differences. I think there is a wider zone in the compatibility area. I would have those two criteria, but I would apply the compatibility one somewhat differently. I wouldn't have any significant difference on independence.

I think the basic matters of independence, like owning stock in the company or having your brother as president and such as that, are no different in a big company than a little one. But, what I am trying to say is that there may be marginal areas in the public arena where you ought to lean over backwards to be sure there is no question of appearance of independence.

MR. GARRETT: We are about out of time, but I don't want to totally frustrate Lou and Dick and Charlie. Do any of you have a question there that you would like to put?

MR. CHARLES R. MANZONI: I just have one.

If the compatibility criteria is an important matter, doesn't it relate to the firm providing it rather than the client to whom the particular service is provided?

For example, the standards now or the criteria

discussed providing certain services to SEC clients, it would seem to me that if you are concerned with an image problem, that image problem would arise by providing it to any one.

MR. CATLETT: I think that is right in general, except to the extent I was commenting previously that it may be even more apparent in the audit of publicly owned companies. The restriction that is in the plan at the moment was put in there by Council which is a higher body than the SEC Practice Section, with the idea that it was an SEC Practice Section, and therefore, its jurisdiction was only for SEC clients. Also, with a lot of Council members being from smaller firms, they were concerned about the effect on smaller firms, so the Council put that restriction in the plan after the interim committee had originally designed it.

When it went to the Council for final approval, it did not have that restriction in it. The Council put it in on the floor of the Council meeting that this would only relate to SEC companies. This is jurisdictional, which is a different point than yours, because you are talking philosophically, but there is a jurisdictional question within the Institute.

How much authority does the SEC Practice Section have to restrict beyond the services to companies that are SEC clients? Philosophically you are right but with some of the variations I have been talking about.

MR. GARRETT: One last question and then I think we are going to have to turn to the next person.

The SEC's release, the recent accounting series release, requiring the disclosure of the percentage that MAS or nonauditing service fees bear

to the auditing fees, I presume is based, well, it must be based on the thought that there is some significance to the relationship. I presume it would be that the higher the percentage of nonauditing fees to auditing fees, the more likely it is that independence has been jeopardized. Is that true? Does that make sense to you?

MR. CATLETT: I assume that is their logic. I personally think they are off on a tangent trying to do something. They haven't done it.

MR. GARRETT: You wouldn't recommend that approach?

MR. CATLETT: I would not. I don't think it accomplishes what they set out to do.

MR. GARRETT: Rather than worry about compatibility, would you say MAS fees can't exceed 25% of audit fees or any number?

MR. CATLETT: I think it is kind of irrelevant to the major issues. I think the SEC felt it had to do something, and it first proposed some other things. It received a lot of flak and cutback and ended up with this. I think it believed that it had to put something out.

MR. GARRETT: They should have waited until we had completed this hearing.

MR. CATLETT: They should have. (Laughter)

MR. GARRETT: Thank you very much, gentlemen. Mr. Vanatta and Mr. Krisher.

MR. CHESTER B. VANATTA: I am Chester B. Vanatta, the Firm Managing Partner of Arthur Young & Company. It is a pleasure for me to appear on behalf of my firm before this hearing the the Public Oversight Board.

In my position as Firm Managing Partner, I have day-to-day line management responsibility for the operations of our firm in the United States. In addition, I am a member of our firm's Management Committee, which is our senior policy committee and equivalent to what some call a board of directors. I am a CPA.

One aspect of my experience might be particularly worth mentioning. That is the fact that eight years of my professional career was in the management consulting activities of our firm--as a staff consultant, a manager, and a partner. This experience is particularly relevant because of the subject matter of these hearings. I have been there--and I know on a first-hand basis the professionalism with which that aspect of the practice of accountancy is conducted.

As Mr. Garrett and Mr. McCloy stated, this hearing is to assist you in commenting on and making recommendations as to the scope of services appropriate for CPA firms, and specifically as to the proposal of the Executive Committee of the SEC Practice Section. Our firm's chairman, Bill Kanaga, participated actively in the formation of the SEC Practice Section and is a member of its Executive Committee. To that extent then, our firm has participated in the scope of service deliberations, although the draft being considered is not consistent with the views of our firm. As a firm, we have consistently maintained that there is no logical basis for restricting a CPA firm's scope of service. We urge the Board to avoid endorsing conclusions arrived at in response to perceived pressures to "do something" unless those conclusions have substance and are based on the facts.

The remainder of my remarks will address fundamental convictions which our firm and I hold regarding scope of service, amplify the reasoning supporting those beliefs, and, finally, make three specific recommendations for consideration by this Board.

OUR BELIEFS

With regard to scope of service considerations, the cornerstone of our firm's conviction is that CPA firms must first and foremost be protective of their public audit responsibility and its impact on the business capital market. In other words, CPAs should conduct their professional practice in such a way that it enhances, rather than detracts from, the credibility of audit opinions. Thus, we believe that:

- If non-audit services provided by CPA firms in any manner compromise the independence of the auditor in fact, such services should be curtailed. (In other words, not provided to audit clients.)
- If non-audit services provided by CPA firms impair audit independence in appearance to a knowledgeable person aware of all the facts, such services should be curtailed.
- If non-audit services provided by CPA firms negatively impact the effectiveness of audit performance, such services should be curtailed.

There is no question in our minds that maintaining the credibility of the audit function is and must continue to be of paramount importance to the independent auditor.

OUR REASONING

As pointed out in our paper submitted earlier, there has been no documented evidence of independence

compromise in fact resulting from CPA firms providing non-audit services. This is true even though there have been extensive research efforts by critics and others. The statistics are truly remarkable--in the 45 years since security laws were first written requiring independent audits, and with the tens of thousands of corporate audits performed in each of those years, not one single case of compromised independence relating to providing tax and management services has been found. In our opinion, this is a substantial hurdle that those who would impose arbitrary restrictions on the scope of auditors' practice must cross. They have not crossed it.

Rather, the criticism of CPA firms providing non-audit services principally rests on a theoretical concern relating to the "appearance" of independence. This point of view conveniently ignores the concept of independence being based on the views of a knowledgeable person aware of all of the facts of an individual situation. The critics seem to maintain that the CPA must appear independent to an uninformed person possessing no facts. Such a point of view is so unreasonable that those criticizing on this basis must have other, unstated objectives in mind.

As to audit effectiveness, in our paper we speak at some length to the point that non-audit services can and frequently do improve the effectiveness of audits and that they do not impair such effectiveness. The knowledge gained from management advisory service involvement with clients enables the auditor to have a greater understanding and appreciation of the client's systems and operating environment and thus can favorably, at times materially, impact audit effectiveness. This is in addition to the fact that having available in the firm the skills used in providing non-audit services is often of invaluable assistance in executing an audit.

In considering the scope of service question, it is important that we remind ourselves of the overall objective the practitioner must serve--contributing to the integrity and the effectiveness of the business capital market of this nation. To our way of thinking, it is preposterous to conceive that the market's ability to function has been negatively affected by CPA firms providing corporate tax advice; suggesting work simplification techniques and assisting in the development of productivity measurement and improvement programs; counseling management as they define the experience and qualifications for a top or middle management position; recommending three candidates as qualified for a division controller's job; designing a cost accounting system; reviewing the effectiveness of the EDP and systems activities of the company and reporting in laymen's terms; or the many other types of management advisory services historically provided by our and other CPA firms. Providing non-audit services has not hurt the capital market. To the contrary, we submit that the capital market and, therefore, the public has directly benefitted. And, such services have been of benefit to private companies served by our firm and others.

OUR RECOMMENDATIONS

We offer for the Board's consideration three specific recommendations which we believe, taken together, are an appropriate basis for scope of service determination, and provide a means for continuing control and monitoring of that scope of service. They are as follows:

1. The Board should forcefully recommend that there be no general proscription of services. In that regard, we suggest you not endorse the accounting and auditing related skills concept of the proposed

amendment being considered at these hearings. Rather, we believe the Board should embrace a concept of prohibiting service to an audit client only when specific services to be provided a specific audit client would impair the audit firm's independence. We believe this is the only service limitation securely founded on logic, and it can only be applied on an individual case-by-case basis.

2. The Board should recommend that individual CPA firms have the responsibility to review the specific services provided with the Audit Committee or the Board of Directors of all public audit clients. While the CPA firm should have primary responsibility for maintaining their independence, the Audit Committee should review on a regular basis the services provided and independently consider audit independence in light of the facts.
3. The Board should recommend that the SEC Practice Section explicitly require that the peer review process include consideration of any potential impact on audit independence from acceptance of non-audit engagements. This analysis should include a review of the firm's policies, procedures and documentation standards, and verification that such acceptance criteria are being followed. These policies and procedures should be such that thorough and thoughtful consideration is given to any potential impact on audit independence. The acceptance criteria we

use and believe appropriate include the considerations that:

- a. We are not acting for, or in the capacity of management.
- b. The client can arrive at an informed opinion on the propriety of our work and recommendations.
- c. Our relationship with other clients or third parties does not pose a conflict of interest.
- d. Personnel assigned to the engagement have no material financial interest in the client or its affiliates.

In addition, we evaluate with great care consulting engagements where decisions made in reliance on our work will be irreversible and are of such importance that the outcome may have a significant adverse impact on the future operating results and/or financial viability of the client.

If needed, the SEC Practice Section could prescribe the acceptance criteria, including specific matters to be considered.

This requirement to include a review of the acceptance of non-audit services in the peer review process would, we believe, complete the loop of positive and continuing control over the auditor maintaining his independence.

These three recommendations would not place artificial limits on the scope of services to be offered by CPAs. Nor do they involve just saying "trust us-- we'll consider the circumstances and conclude what

reasonable men, having knowledge of all the facts would conclude." Rather, the recommendations provide a basis for objective and informed individuals outside of the CPA firm, both outside the profession and within, to have access to all the facts and judge whether audit independence would be or was impaired.

The accounting profession has been preoccupied for the past 18 to 24 months with issues relating to its internal operations, its structure, and its scope of services. We sincerely hope that the Board will take a forceful stance along the lines of our recommendations and by so doing contribute materially to clearing the air on this subject. Such action would serve the profession well--allowing us to turn our full efforts to serving clients and fulfilling our responsibilities to the users of financial statements. Such a refocus would without doubt be in the public interest.

Thank you.

MR. VANATTA: I appreciate the opportunity to be here, and I will be happy to respond to any questions that you might have. I assume you will have some.

MR. GARRETT: Thank you, Mr. Vanatta. Mr. McCloy, have you any questions?

MR. McCLOY: I may have some questions as we go along, but I am thinking of a comment. I don't place as much value, as you seem to do, on this lack of record. I am not so sure that the lack of record is all that significant. I am not so sure how that record would appear.

There may not be any cases on it, but in fact, if there was a lack of independence there, I don't know that it would come up in the courts. It is a more subtle thing.

MR. VANATTA: I think that we are reasonably close together, Mr. McCloy, I believe that it is a

consideration and an important consideration, particularly if logic will not support prohibiting certain services.

I give it, I guess, more weight than you do, because of the tremendous efforts that have been made by various people in attempting to identify situations where independence might have been compromised.

My recommendation, and specifically the last of the three recommendations, addresses the substance of your point. I am recommending providing a positive mechanism for informed people who can reach a knowledgeable conclusion, having access to the facts, which possibly critics or others didn't have.

MR. McCLOY: I recognize that. I keep coming back to this classical analogy of Ceasar's wife. She has got to be above suspicion no matter who the gossip is in the street in Rome. And there is suspicion perhaps since the Cohen Commission said there was a significant minority that expressed some doubts. When they used "significant," I guess they were meeting your point, or at least, they are subconsciously meeting your point. This was not an ill-informed group.

MR. VANATTA: On that point, Mr. McCloy, and I always kind of chuckle when I see those two words together--significant minority, though I do not disagree with the Cohen Commission on any of their research or their findings and conclusions in that area, I think it important to also point out that their research, their studies, and their findings were that as individuals better understood, became more informed and were closer to the scene of what was actually happening, in other words became more knowledgeable, the concern significantly decreased. I think that is a very, very important point for this Board to consider.

MR. McCLOY: I may want to come back.

MR. WOOD. You offered three criteria. The

second one I noted was that services should be prohibited when it is clear that they would impair the independence of the audit firm, and suggesting it be applied on a case-by-case basis.

MR. VANATTA: Yes, sir.

MR. WOOD: Can you give us an example of a service which would clearly impair independence?

MR. VANATTA: Can I give you an example of a service?

MR. WOOD: Of a service performed by a CPA firm.

MR. VANATTA: Yes, a service that would not meet the criteria that I mentioned in my prepared remarks, that would involve doing work that we believe management does not have the capability to review, to reach informed conclusions concerning. In other words, acting in place of management.

There are disagreements within the profession, and I think honest disagreements in the main, but I would include in that particular category what is called turnkey computer services.

By definition turnkey, as we explain in our paper, involves doing all of the work involved in the design and programming of a system or installing a prepackaged system, testing it, getting it operational, and turning it over to the client.

I think by definition that implies that there is not the adequate amount of client participation in reviewing the work, in reaching informed judgments concerning the propriety of the work and in assuring themselves that everything has been considered in their individual situation.

That is an example of where I believe one could get into at least the fringe of acting in place of management. If it is a semantics problem, then let's not call it turnkey. Let's call it full

implementation work.

That would be a form of, and there are all kinds of others, original, specialized services but it does not have the necessary management participation involved.

MR. WOOD. In many of the papers submitted, we see the principle of many accounting firms that their service should be advisory, and of course, should not be managerial.

I think you are saying the same thing. You would not provide a turnkey computer system. You would advise management.

You didn't mention advisory services as opposed to management, but you are saying the same thing.

MR. VANATTA: If I understand your comments, I would agree with you. You are paraphrasing what I am saying accurately, yes.

MR. WOOD: What you have just suggested brings to mind a service which I think could be important to management.

Suppose your firm in looking at the computer system and the controls that are built into the system, let's say on accounts payable, you found that the computer staff of the client was, in your judgment, inadequate, you would have to go to management and say: "We don't want to tell you what this system has to be and oppose it, but your staff, in our judgment, must have competent people," then management asks you, "Can you find us one?" What would your response be then? Would you engage in helping management to find a competent person?

MR. VANATTA: We would assist management, and this gets into, the area that you are asking about, I assume, is that of executive recruitment services.

MR. WOOD: Right.

MR. VANATTA: And Mr. McCloy, I don't like to

call it head hunting, as you kiddingly referred to it earlier.

MR. McCLOY: An unfortunate connotation.

MR. VANATTA: I am talking about professional executive recruitment services. Yes, our firm does have that included in our scope of services. In the particular situation you describe, according to the level of the position, if it would meet both our professional and business criteria, we would participate and accept an engagement to assist the client in finding suitable and qualified personnel to meet their needs.

I don't mean to be picking on words, but I think it is important from a concept standpoint that I elaborate on the question, "Would we locate a person?" We would first assure that we understood the needs of the position. We would discuss this with management, possibly assist them in their thought process of defining the requirements, experience needed, et cetera, for the position.

Then we would seek out qualified candidates, individuals that we thought would qualify for the position. Do appropriate reference checking, do appropriate interviewing with them, and would recommend an individual to that client as in our opinion being qualified and worthy of consideration for the position.

We have as a policy to recommend never just one, but three people as qualified, and the client management themselves are the ones that make the selection, make the decision, and we do not get into negotiating with the client on behalf of compensation, fringe benefits, that kind of thing. We believe this is a service that our clients need. We believe that we can provide it and do provide it on a professional basis, that we consider all of the independence aspects related thereto, that it does not compromise independence,

or if it would for any reason, we wouldn't accept the engagement.

We believe that when there is a client need that in some way there is going to be assistance from the CPA firm. I don't care whether you want to call it casual referrals or what. We believe that the need can best be provided on a professional consulting basis subject to all of the disciplines of the practice.

MR. WOOD: Thank you.

MR. VANATTA: I didn't mean for that to be such a long answer, Mr. Wood.

PROFESSOR CARY: I have only one question, but it stems from what Mr. Wood has raised.

What if you found that one of the Big Eight announced they were going to merge Booz, Allen, Hamilton or McKinsey & Company. What would your reaction be?

MR. VANATTA: Surprise--great surprise.
(Laughter)

PROFESSOR CARY: I assume. That is why I asked it, but not let's see what is wrong with it in terms of no restrictions. You said there would be no restrictions.

MR. VANATTA: In my opinion, Mr. Cary, there would be nothing wrong with it. The previous person appearing discussed what was termed compatibility. We use the term image in our paper. I think you have to be very careful to not get image mixed up with independence. That is very, very important.

In the previous discussion, and I think I am addressing the question, you talked about getting into geology and so forth.

Mr. answer to that is that I would not prohibit that. Our firm is not going to go into the geology and so forth.

My answer to that is that I would not prohibit that. Our firm is not going to go into the geological engineering business, but logically, I see no reason why those services should be proscribed. I would, rather than attempting to react to all kinds of different perceptions or desires for image, I would let the marketplace make that decision. I believe if a CPA firm starts diffusing its focus too much, and if there truly are questions among business as to compatibility, image and the kind of firm that they want to associate with, the audit committee of the board of directors that are going to be reviewing your firm's scope of services would forcibly speak through their decisions. I believe, even if one were to assume that just major firms would do it, that the marketplace should make the decision rather than an arbitrary decision being made by any particular body.

PROFESSOR CARY: That is quite an adequate answer. I mean, that is an answer all right.

MR. VANATTA: If it is not adequate, I would be happy to enlarge on it. (Laughter)

PROFESSOR CARY: You haven't limited yourself, put it that way.

MR. VANATTA: Because we believe as a firm, and I personally believe, that it would be inappropriate to artificially limit scope of services.

MR. WOOD: I have one more question, Ray. You suggested that the audit committee of the board should review the services that the CPA firm engaged provides.

MR. VANATTA: Yes, sir.

MR. WOOD: And the audit committee should make the determination whether these services would affect, or impair independence. I believe that was it.

MR. VANATTA: I indicated that the CPA firm has the primary responsibility for being independent, that the audit committee in their role, or the board of directors if there is not an audit committee, I believe should have the responsibility as an audit committee for reviewing the facts and reaching their own independent conclusion as to whether they agree or not with the CPA firm.

MR. WOOD: Audit committees, as we know, have had a lot of attention. All listed firms now must have an audit committee of the board.

I am just wondering whether they are going to be competent to make this judgment. They haven't had the benefit of these hearings, and study of all these fine position papers from the profession.

I am sure that Mr. McCloy's Audit Committee, and he is chairman of two or three, is pretty sophisticated, but I am just wondering whether in the great cross-section of American business, you have got on boards of directors, people who are going to be able to do this especially if we get too much complication, and the AICPA in its wisdom finally decides on very particular parameters and definitions.

MR. VANATTA: I believe I understand your question, Mr. Wood, and I think that the generic problem of enough qualified members for audit committees and so forth, which you are suggesting is a related issue, some people do think is a problem.

I would not agree with the conclusion that your reasoning would seem to lead one to, and I personally believe that if we were to take that tack, we would be underestimating the capability of members of the board and audit committees. If one does not have the background, if one cannot get the background, if one can't go to some educational sessions that CPA firms and other for-profit organizations are

holding, to be able to perform effectively as an audit committee member, then I think we have some other larger problems, but I would not artificially restrict the scope of a CPA's services because of that. Why penalize CPA firms in their services because audit committees are perceived not to be able to do their job?

I do have the other additional restriction or control, of course, built in from the standpoint of professionals themselves reviewing through the peer review program the independence question as related to non-audit services.

MR. WOOD: I think this has been constructive in the sense that we, the AICPA, when this issue is resolved, would, and it's your suggestion that audit committees should always question CPAs in their twice-a-year or at least once-a-year review with them on the services they are performing, I think the profession can do a real service for American business and boards in providing the same kind of material that you have already provided the audit committees, and I have read them, the pamphlets of several of the Big Eight firms, at least--what the audit committees ought to get into.

MR. McCLOY: I come back, if I may. I was thinking about this thing. Particularly if you are talking about audit committees. I have had that experience on audit committees.

MR. VANATTA: Extensive experience, I understand.

MR. McCLOY: I find in some cases that they have had difficulty in finding outside directors. I am not sure the ruling was a good one that the SEC put out.

I am inclined to think maybe if you had one member of the management that knew something

about the business, it might be a better audit committee than if you had just X, so many black, so many white, so many feminists, so many people, whatever you have to do.

MR. VANATTA: I was with you for a while.
(Laughter)

MR. McCLOY: So that I think there is something in the thought that maybe it may be too easy to get the expert outside group of directors, knowledgeable outside directors. That will come about in time, but for the moment, I think they are having some difficulty with it because almost by hypothesis they want to put on the audit committee somebody that has nothing to do with the business.

The other thing is about this recruitment of executives.

I may be one of the uninformed in the streets that you were referring to whose judgment you shouldn't be given much attention.

I have a gut reaction to this thing-- that it is unwise to have this all out service of obtaining executives or the chief accounting officer and to sort of commission an accounting firm that is doing your auditing to find that man for you. I just think it might encroach upon this concept of independence.

Maybe it isn't complete. Maybe you haven't got any record of abuses, but as I say, I have a gut reaction against it. I have a feeling that with the accountancy profession, as with my profession, there is some opprobrium at the moment. You have to duck when you say you are a lawyer, and you have to duck when you say you are an accountant in view of some of the records we have had and some audit failures.

Maybe there is a pressure, as I say, to be

above suspicion, as Caesar's wife, and maybe you ought to eliminate it, just for the sake of the reputé and the importance of the credibility of the accountants.

MR. VANATTA: I understand the point of view you are expressing, Mr. McCloy. I respectfully disagree with that line of thinking, though I do agree that there is some suspicion--you mention your gut reaction. But I don't think that important decisions affecting certified public accountants, their clients and others, should be made just on feelings, on emotion. The problem is I don't know where it stops then. Whose feelings, whose emotions, whose reaction? I think that it is important to consider that aspect of it.

I understand and respect your viewpoint.

MR. McCLOY: I feel that there are some things the accountants can do in the MAS field that are helpful to the audit. However, this on I react to, and I think that informed people do.

Now a query: Is this something that you should take into account or that you would take into account if you were in our place?

MR. VANATTA: I think you should take it into account. I would not get into quantifying the impact that it should have on you. I think this is indicative of the need, because executive recruitment is a focal point of an area that is easily discussed and one can have strong feelings on it one way or the other, for the whole thought process to really be thought through clearly and that you take into account the future implications for other areas of decisions that are made in this particular area.

Also, I would suggest that you take into account the feelings, the reactions, that people

have in this kind of a thing, providing executive recruitment on a professional discipline basis, and compare that to what the feelings, what the appearance might be, of the CPA partner referring one of his close friends, a person he has worked with, to that organization, or of placing one of their partners with that organization.

I think that the whole area must be reviewed before any conclusion is reached.

MR. McCLOY: This is one of these situations where you have to face the dilemma. As Mr. Churchill used to say to me frequently: These are some of the goddam bloody dilemmas of life. You have to make the judgment. (Laughter)

MR. VANATTA: Mr. McCloy, I know it doesn't apply to you, and I mean that sincerely, but when you are referring to attorneys and others who feel like they have to duck, and this is going to sound like waving a flag, I must say I think that is one of the problems. Too many people in business and the professions and others have ducked too often, and we need to stand up and be counted on these matters that I think are very important.

MR. GARRETT: Thank you, Mr. Vanatta.

MR. VANATTA: Thank you.

MR. GARRETT: Before we break for coffee I think I ought to observe that the legal profession somewhat excels the accounting profession in getting into trouble. After all, we got raked over by the President himself and all you have been able to attract is a retiring Congressman and a deceased Senator. (Laughter)

But with a little effort. (Laughter) I would like when we resume, our next person will be Mr. Arnstein. Is he here? Good. How about Mr. Green

who follows him? And Mr. Auerbach. Thank you very much. We will take 15 minutes.

(A short recess was taken.)

MR. GARRETT: Let's reassemble. Lou Matusiak has had several questions with respect to the availability of written comments or prepared statements, that have been presented to the Board. They are all publicly available documents. They are physically available at Lou's office in New York City or he will send you a copy for the cost of copying if you will write him or give him a note to that effect.

With respect to copies of the transcript, it is also public as a matter of policy and can be examined at the office of Lou Matusiak or I am sure you can order copies from the reporter if you wish to do so before you leave.

We will proceed with Mr. Peter Arnstein of John F. Forbes & Company. Mr. Arnstein, please.

MR. PETER ARNSTEIN: You have my written statement, and I will try to summarize it and maybe make some observations which are not in the statement.

Our firm is a regional firm. We have approximately 200 professionals. We are regarded as a small firm by the large firms and a large firm by the small firm. (Laughter)

We have 9 offices. We practice entirely on the West Coast. We figure that approximately 12% of our revenue is derived from clients who are registered with the SEC.

As with smaller firms, a much higher proportion of our revenue is derived from tax services and approximately 6% from a formally organized MAS service.

I am Chairman of the Executive Committee of our firm, and I am responsible for its accounting and auditing practice.

Since 1961, I have served on various Institute committees, including the MAS Committee. I was for six years on the Institute's Ethics Committee and Chairman of its Independence Committee for three years, and during that time I conferred with Andy Barr, the former Chief Accountant of the SEC, on many occasions. In my position with the firm, I am often called upon to settle or resolve potential or actual independence problems and I was a partner in charge of MAS services when we were starting it, going into that field, in the early Sixties, and I am primarily an auditor.

During all of this period, for at least 15 years, I have been dealing with the management advisory independence question in these various capacities, and I am interested in seeing it resolved in a way that is beneficial to the public, business, the profession and won't hurt our firm.

I think that the two previous gentlemen who were before this Board, and it is quite apparent to me

that you gentlemen recognize the problems, are well aware of the problems, and I would just like to say this, that I am persuaded with these years of experience with it that the only practically sound and theoretically sound criteria for restricting MAS services is on the basis of independence; and that with respect to the performance of non-audit services, role is the only theoretically sound and practice manner to do it.

We have had a lot of experience with role, and it is a practical approach, and for example, the question of executive recruiting and particularly head-hunting for senior executives is concerned, there is a question, I think, whether the role of the auditor is compromised by hiring a chief executive because inevitably no matter what the auditor does in separating himself and being an independent consultant, there is a possibility that he has a vested interest in the success of the executive whom he has been instrumental in placing.

When it comes to skills and the breadth of services that are performed, there has never been a case where some audit failure was dependent on the performance or lack of independence resulting from the performance of non-audit services. As an audit partner over a number of years and as the top authority in our firm for settling these problems that come up in connection with audit independence, and even in our size firm they come up often, and when we feel that our objectivity is threatened, I would say 99.9% of the time the problems come up in the context of our suggesting adjustments to the client's financial statements to which the management objects. There is, I would say, the fundamental nexus of independence, that is, if we don't come to a satisfactory agreement, we may

be fired.

That is overwhelmingly the situation that prevails, and really nothing else determines real independence except how the auditor performs under those circumstances.

Even in our practice, and quite frequently with non-SEC clients, contractors who have to show a certain net worth in order to get adequate bonding, private companies who have to show liquidity in order to get credit, family-owned companies where some of the family owns part of the company but is not in management, and another section of the family operates it and the non-managers are often very critical of how the operating part does, so that the question of what the financial statements are going to show and what the auditors are going to say about it comes up quite frequently. Overwhelmingly the objectivity and integrity of the auditor is tested under those circumstances. MAS never comes into the picture.

I think we realize, and I think Mr. McCloy particularly has focused on the problem that when it comes to publicly held companies, we have to be like Caesar's wife. There is this gut feeling that certain services dilute the auditor's image as an expert or somehow they don't seem right.

When we were trying in the MAS Committee in the early Sixties, and this was my first exposure to this problem, to describe an appropriate scope of services for CPAs, immediately those firms who don't perform psychological testing, and we don't perform psychological testing in our firm, said, "Well, obviously, you shouldn't do psychological testing," and those firms who did psychological testing had all kinds of very good reasons why they should do psychological testing. I think they were probably right. I think, for example, you can make a pretty

good case that if we as auditors had the results of psychological tests of some of the chief executives and financial officers of the firms we audit we would be a lot more knowledgeable than going out and counting inventory (Laughter) because when we do get into some of these audit problems and we discuss among ourselves, that it, within the firm: What are the motivations of this particular executive? Is he really telling the truth? I think that if you examine audit failures, and I have been involved fortunately not as a defendant but as an expert in assisting lawyers in some of these massive audit failures, perhaps if the auditor could have knowledge that the chief executive really was a liar, or as in the renowned case of McKesson Robbins really wasn't the person he purported to be at all, (Laughter) it would have been very helpful.

So that you can make a strong case for psychological testing, but there is this gut feeling that maybe auditors shouldn't do it. In order to satisfy this substantial minority of people who are less acquainted with what actually goes on than anybody else, I think that we can acknowledge that some restriction should be made so that these questions don't arise.

The important thing, and it is particularly important to our firm, is that if such restrictions are made, that they are completely separated from independence considerations. They are acknowledged as image problems that have no logical basis and are simply being made to satisfy the critics, and I may be putting it in an unnecessarily negative aspect, but that is the way it ought to be done, so that there is no spill-over to the very valuable non-audit services that firms of our size perform for our non-SEC clients.

As you acknowledge, and I think you realize, most of our size clients do not have CPAs on their staff. They rely on us. They do not have computer specialists. They rely on us for all kinds of things. We are in an excellent position to serve them.

As an auditor, we probably are, as other auditors are, the outside person who goes around and is more intimately acquainted with our clients' operations and how other businesses operate than others, and I think over a period of years we get a very good idea why some businesses are successful and some are not, and you might say our function as a bee spreading the pollen of success is an important one, in the economy of this country. So that if some way our services are to be restricted, then it is for public image, and it is not based on independence because there is no theoretical reasoning or experience that says that independence is affected as long as role is maintained.

I would like to also comment on the accounting and auditing skills criterion. I think that we have certain criticisms with the restrictions and the reasons for the restrictions presently contained in Section 4. I have read it and read it and read it, and I still don't make too much sense out of it. I am presently a member of the National Review Board and have been a member of the Trial Board panel, but particularly as a former Ethics Committee member, I would not want to underestimate the ability of the Ethics Committee or any other technical committee in the Institute to sit around and, maybe in this room I have spent days, certainly one of these rooms down on this floor, trying to dissect similar problems, and we don't get to a resolution. I would say in the examples of what are accounting and auditing skills and what are not, there is probably in each one of

these categories food for weeks and months of argument and discussion. I agree entirely with my friend, George Catlett, on role as a criterion. I think also I would like to say that the thing that is implied in here is that perhaps our tax services are affected because in one of these documents, tax advisory services is defined as a non-audit service. As is entirely logical, most of our clients ask us to prepare their tax returns. They have nobody in the firm that can do that. Generally in our firm our auditors prepare the initial draft which is a logical outgrowth of their auditing.

They assemble the information. When you get down to a client's bottom line, half of it may go to taxes, and so we get a very good idea of what the tax problems of the client are. We get some ideas as to maybe how they can be improved or where the trouble areas are. It is very logical. Accountants have always been involved in taxes, and we feel that there is an implied threat and a spill-over that possibly because taxes in some sense are an adversary procedure, that down the line it will be prohibited even though the jurisdiction has been limited to services for SEC clients. As has been previously pointed out, it is impossible to distinguish independence questions vis-a-vis public and private companies. It is possible to distinguish image problems, and if image is a basis for proscription, as it may very well be, then it can be acknowledged that it will not affect services for privately held companies.

I think I have covered most of the material in my prepared remarks. I appreciate the opportunity to be able to present them to you.

MR. GARRETT: Thank you, Mr. Arnstein.
Mr. McCloy, do you have any questions?

MR. McCLOY: You constantly referred to role as distinguished from skills. Would you just elaborate on it. I have read your written statement. You talked as if you only looked at this from the point of view of role the problems would be resolved. Will you elaborate on that. What do you mean by "role" and what should be our approach to this dilemma that we refer to? Tell me how that term helps us.

MR. ARNSTEIN: I think role is an acknowledged part. It has been embodied in the independence literature. It is embodied in the rule that an accountant or an auditor should not perform any management functions, and there is a long history, as a matter of fact, at the present time. Take a simple matter like auditing our own work, and at the present time the profession's position is somewhat different from the SEC's position as to what part an auditor can play, let's say, in keeping the books.

I was the Chairman of the Independence Committee when the current interpretations were issued, and you might say we agreed to disagree. We came pretty close but did not entirely agree, and role is a difficult thing to judge as to where you cross the line because we have had publicly held clients where the client really didn't know how much money they had made until we got through with our audit. We may make 150 journal entries. Let's say all the important ones. Have we kept the books, and accountants sometimes add things up by the number of journal entries although some may be for 25 dollars. We hope not, and some for half the profit, but for example, how do you measure it? When you get over 100, have you kept the books or not?

MR. McCLOY: Do you mean in management?

MR. ARNSTEIN: So it is a difficult thing. Yet, I think it has always been acknowledged that role

in the performance of non-audit services or in the performance of accounting services is an important consideration in determining whether you are independent or not. We have addressed it, and we can distinguish.

In my written statement, if it is independence, it ought to be decided on role. If it is not independence, and role is a part of independence, then it ought to be image. We can't separate independence between private and publicly owned companies, but we can separate image. Image is a public thing, but independence is pervasive throughout public and private practice.

MR. McCLOY: You talked about taxes. It seems to me as long as I can recall, accountants have been preparing corporation returns.

I am thinking of what we are probably going to hear this afternoon from the actuaries. They make a big point about the vice that is involved in reviewing your own work.

Aren't accountants reviewing their own work when they do the tax returns? They can come to the audit, and they must make a decision that the tax work has been well done before they make the attest. Isn't that reviewing your own work?

MR. ARNSTEIN: That is right, and to a certain extent it is. I think you could say that taxes, the income taxes, are a result of the operations of the company so that no matter who does the work, you are going to come up with a figure.

MR. McCLOY: It is an interpretation of the law.

MR. ARNSTEIN: It is an interpretation of rules, but then we as auditors are in the position of interpreting accounting rules which go right to the heart of the subject.

When the chief executive officer and the

chief financial officer as they presently do sign representation letters that they are responsible for the fair presentation of financial statements in accordance with generally accepted accounting principles, often they know very little about generally accepted accounting principles, and we know a lot more and we tell them what they are, so it is a difficult thing to separate.

MR. McCLOY: You have had a lot of experience, as you point out in your qualification statement. Suppose you should put yourself in our position. What MAS would you proscribe and what would you permit.

MR. ARNSTEIN: Since the objections are not based on logic, I think, and some of the services that are already proscribed as part of the SEC Section rules, are services which are mentioned as kind of offending the propriety of "the public" if you put quotes around "the public," and are services which seem far removed from independence considerations, although they may not necessarily be removed from independence considerations, although they may not necessarily be removed, I can't say except that it be based on what is the image? And the determination of image is a nonlogical process. I think that somehow or other the Board has to get a feeling for what will satisfy this public out there and say that the image of the profession is unfavorably regarded because certain firms perform these for public clients and considering the pluses and minuses, just proscribe them. To a certain extent it is just like dealing with unidentified flying objects. It is not a logical process.

MR. McCLOY: Thank you very much for that. That is great help. (Laughter)

PROFESSOR CARY: It is realistic.

MR. RICHARD A STARK: I am not sure that

I understand the distinction you are making on the image point. You say image is a public matter and that proscriptions should apply only those performing SEC work or work done for SEC clients.

I would have thought that the public that you are referring to would be the persons relying on the financial statements. Whether it is a broad public such as shareholders of a publicly held company receiving financial statements or a narrow constituency such as the nonmanaging owners of a company that you spoke of or the creditors, there would still be a public perception and I would think it would be important to preserve whatever image qualities are desirable in either case.

MR. ARNSTEIN: I think that the term "image" is unfortunate and perhaps George Catlett's term, compatibility, is a little better because it is hard to distinguish image from appearance because in judging independence questions we use the fact and appearance of independence. But image doesn't have anything to do with independence because in practice we know it doesn't affect independence as long as role is maintained, and that other things are very much more important.

We should acknowledge it is image, and I think that if you look at the polls and so forth, that the people who seem to have the idea about non-audit services affecting independence are generally people who are removed from the scene. I think Mr. Vanatta referred to that.

One of the significant findings is that the more people know about it, the less they are worried about MAS service. So when you get the smaller companies and everybody knows everybody else, I don't really think that they are concerned with that subject at all. Really, it is all those

people out there who are the public, and have very little contact with it.

MR. GARRETT: We are running a little late. Do you have any further questions?

MR. MATUSIAK: I have one. If I understood Mr. Catlett's position correctly, he would proscribe the rendering of any services by a firm that had an SEC client. You seem to say that you can render some services to non-SEC audit clients that would be proscribed to an SEC audit client. Is that correct?

MR. ARNSTEIN: That is correct.

MR. MATUSIAK: You are not afraid that there would be some spillover over time or that if you were an auditor for a non-SEC client and you rendered to them a service that you would not render to an SEC client, that you would have no problem with that?

MR. ARNSTEIN: Well, I am worried about spillover and very much worried, and therefore, I think the essence of my statement is that if the proscription is based on image and image is a concept of the public and if non-public companies don't have a public, so to speak, that the spillover won't occur as long as it is adequately contained.

PROFESSOR CARY: Mr. Arnstein, I just wanted to relate myself to one point in connection with your type of firm.

You indicate yours is a 200-man firm, professional firm, and obviously, as you say, you can't speak for the small firms, and yet perhaps you have a better impression of firms below that than the big firms do. I am not sure, but I will accept that for a premise for a moment.

If that is the case of the firms with the number of professionals of your size and less, when you speak of their performing MAS services, is it the same kind of MAS services that we are talking about

vis-a-vis big firms? For instance, how many firms below your size have computer specialists, for example? They wouldn't have anybody who was doing formal executive recruiting, plant layout, actuaries, would they?

I am just wondering what are we dealing with in terms of organizations of the 200 professional or less?

MR. ARNSTEIN: I can't speak exactly. All I can say is that the practice of firms our size and smaller vary a great deal.

I do know of smaller firms than ours who are in psychological testing.

PROFESSOR CARY: And never had any logical testing in these firms? (Laughter)

MR. ARNSTEIN: I do know of firms, for example, that specialize in marketing and so forth so that I don't know what the impact is, but I don't think it would be wise to make an assumption. In fact, I know it wouldn't be because I do know that there are relatively small firms who specialize in what can be regarded as non-audit practice.

PROFESSOR CARY: I am amazed that a firm of under 200 could be engaged in psychological testing and anything that is somewhat, shall we say, way out relatively, and still perform the auditing function which is its primary function.

MR. ARNSTEIN: In this particular firm, I think the managing partner is a graduate psychologist as well as a CPA.

I am a graduate engineer, although I wouldn't want to build anything for anybody. (Laughter) I would say also that you referred to computer specialists. In this day and age almost any firm has to have one.

PROFESSOR CARY: That is probably one area

plus the taxes, you said.

MR. GARRETT: Mr. Arnstin, in your experience or observation, do you gain or lose clients because of the variety or the quality of this MAS service?

MR. ARNSTEIN: There is no question about it. If we don't provide a full range of services of what accountants are expected to provide, then they will go to competitive firms which can provide all of those services. For example, this I have got to say, comes up in executive recruiting a good deal. When a client is looking for a chief financial officer, they ask us, and we very much want to supply one because they will go and ask a competitor, and then maybe this gets into independence to a certain extent.

A competitor will place their own man, who will feel loyal to this other firm and all kinds of things like that.

MR. GARRETT: And change auditors.

MR. ARNSTEIN: Sure.

MR. GARRETT: Thank you very much, Mr. Arnstein.

Mr. Green. Eric Green of Harris, Kerr, Forster. Is this Mr. Noonan coming with him?

MR. ERIC F. GREEN: That is right.

MR. GARRETT: Proceed, gentlemen.

MR. ERIC F. GREEN: I am Eric Green. This is Donal Noonan. We are both very much pleased to have the opportunity of being here.

Perhaps by way of introduction, I should just say a few words about our firm. We are one of the smaller of the national firms.

We also happen to be rather a strong international firm in public accounting and in management advisory services.

Both of us CPAs. Both of us have spent many years of our lives as audit partners, and both of us now dedicate, I would say, 95% of our time to our MAS practice.

In our written brief we have pointed out some of the areas in which we are rather specialized, and in some respects we are rather unique in providing certain types of MAS services to our clients, both audit clients and non-audit clients.

Very briefly, the position of our firm in respect to scope of services, is that no restrictions are warranted such as those that are proposed. We believe that they would be harmful, unjust and completely uncalled for by any past events. These points have been already mentioned by other speakers.

We are confident of our own ability to decide, guided by our own internal rules of conduct and those of the MAS Practice Standards of the AICPA that we can decide for ourselves the scope of services that we should provide.

We do not doubt our independence in rendering them, and we also know from experience that our clients will decide whether we are the best suppliers of their needs.

A free market exists particularly with respect to the provision of management advisory services, and we believe it should continue to

exist without harmful regulation.

However, rather than dwell on the negative side, we should like to draw the Board's attention to the positive values of MAS services to audit clients and others. For example, we see demands from governments for better, more comprehensive audits of economy, efficiency and effectiveness, and they are certainly needed.

We have SEC requirements for disclosure of replacement values of assets. The private sector is constantly seeking new insights into its operating methods and businesses turn to their public accountants for study and advice. They also turn to other business consultants frequently on a highly competitive basis.

That is to say that CPA's management advisory services have grown because there is demand for them. It is not that we went out and invited them, as it were, but people came to us to provide the services, and in fact, we believe that CPAs in general are often the most efficient, economic and effective suppliers of those services.

We believe that the benefits that accrue to stockholders and to the economy as a whole, when services are rendered, greatly overtakes any possible dangers that some allege exist.

It is asserted in the summary of notice 78-1 that the practice of public accounting has its origins in the attest function. In the case of our firm, at least, the MAS function preceded the attest function to some extent, certainly in the United States.

When our firm came here in 1911 at the request of an English client, it was to provide essentially what are now referred to as management advisory services because of a perceived competency

that we had in the kind of services that that client was looking for.

Our management advisory services are still provided internationally, and it is important to us and to our firm that they continue.

As the private sector seeks to expand overseas, it seeks the advice of its business consultants. Many of our MAS services involve our overseas offices. Our British associates who are already, as I am sure you are aware, living in highly regulated society, have expressed amazement at the proposed scope restrictions that would affect them also because we must practice as one firm in our international work.

They ask us: How can we willingly abridge our rights to practice professionally when no public good is promised except in the minds of our detractors? Unfortunately, the issue has become political rather than professional, and as we say in our written brief, we have serious concern that the proposed proscriptions will be unconstitutional restraints on our rights to practice our profession.

I am going to ask my partner, Donal Noonan just to say a few words on this other political question since so many other speakers are covering most eloquently some of the more professional aspects of this discussion. If you would, Don.

MR. DONAL C. NOONAN: Gentlemen, I am a CPA by examination in New York and by reciprocity in California. I practice in California now, although originally I was in our New York office.

I am also an attorney admitted to practice in the State of New York, and Mr. McCloy, I hope I don't have to duck twice when I say that.

The certificate granted me by New York and by California, and to my fellow CPAs around the country

in the various states, permit me to hold myself out to the public as a certified public accountant, but I do not find in any place that this grant of status restricts me in the pursuit of an honest livelihood in the business world.

You have in the record the position of my firm and have heard the comments of my partner and colleague, but I would like to approach the issue from a different perspective.

First off, I would like to add my whole hearted personal endorsement to Chester Vanatta's comments. They were most eloquently presented.

The professional public accountant is highly regarded and respected for his integrity, his independence, his objectivity, his competence, his knowledge of the client's affairs, his knowledge of the client's business, and by education, which does not stop upon attaining an undergraduate or graduate degree but is a life-long process, he has frequently many other attainments. You heard Mr. Arnstein state that he has an engineering degree, and there are many CPAs who have degrees in other than auditing and accounting.

By experience gained in the marketplace and in the field and in industry, he attains a knowledge and a capability far beyond that which we would normally associate with the attest function alone.

By application of his knowledge and testing of that knowledge and his experience to problems of his clients, he has demonstrated to the community, to his clients, his ability to undertake and solve complex business problems.

The accountant as professional adviser, as a diagnostician of business ills, as a dispenser of curative advice, has established a standing in

the business, financial and industrial community that is the envy of those less qualified or worse, those whose motivation to criticize is politically based and on a "popular" concept, if you will.

I submit that our reaction to the so-called Senate staff study, the Metcalf report, if you will, is indeed an overreaction to a witch hunt.

The very title of the report, The Accounting Establishment, reveals the underlying bias and lack of objectivity of its authors.

The pronouncement of other politically motivated individuals including one from my present home state are replete with innuendoes and charges and false assumptions and peculiarly lacking in facts or case studies. Broad generalities based on pure assumptions can confuse the uninformed segment of the public perhaps, but should not confuse us.

Witch hunters will always find witches. UFO hunters will always find UFOs. And leprechaun seekers, my parent's native land, will always find leprechauns, but we should direct our efforts toward seeking the truth and toward educating the public in the truth and not waste our time tilting at windmills set in motion by misinformed, biased, politically motivated, would be critics of our professional activities. There is not a scintilla of evidence that the independence, integrity or objectivity of any CPAs have been compromised or impaired by management services performed for audit clients or any other clients.

The charge itself is an insult which demands proof from those making the charge and not proof of a negative which is an impossible feat.

We should avoid even the appearance of seeking isolated instances or claimed instances of

lack of independence, but rather seek out the truth, the real benefit to our clients, to the community and to society as a whole of the advisory and consulting services performed by the accounting profession.

I believe that an analysis and perhaps a scrutiny of the motives of our detractors will disclose a conflict of interest there, that is to say the least, unbecoming their status in the community and demeaning to the integrity of the profession of which I am proud to be a member.

I recommend that the proposed Amendment be rejected. I thank you.

MR. GARRETT: Thank you, gentlemen. Are there questions?

MR. McCLOY: Is there any area that you proscribe or any types of business advice that you refuse to give?

MR. GREEN: We are very careful only to accept engagements that we feel we can complete with full competence and due care and all the standards that are applicable, I think in general, to CPAs' work, but specifically are documented in the MAS Practice Standards. So yes, if someone comes to us to undertake a study for coal mining, for example, we would say: No, that is not our expertise, and we would perhaps try to find the right firm and recommend them, but no, we would not accept engagements that we didn't feel we could complete.

Does that answer your question?

MR. McCLOY: I guess it does.

MR. NOONAN: Might I just piggy-back on that. In the past where that situation has occurred, and it has occurred frequently, we have joint ventured, if you will, assignments with other professionals in the performance of assignments which included our expertise applied to the project at hand coupled

with the expertise of others.

So that if we have any question as to our own competence, which we would have as a natural outcome of, for example, studying a coal mine, we would.

MR. McCLOY: You would go out and get a coal expert to help you. Is that the idea?

MR. NOONAN: That is the idea. Dig out the facts.

MR. McCLOY: There is no limit.

MR. NOONAN: There is no limit we can see to place on the profession. I think if we individually place a limit on ourselves, because of our own evaluation of our own competence, that is one thing, but to place that limitation on the entire profession is, in my opinion, an error because there are others within the profession who would have that competence and to whom we would direct such a client or potential client.

MR. WOOD: Would you have different members of the firm performing management advisory services and a check on the accounts and internal controls in the final certification of the attest function?

MR. NOONAN: Yes, as a matter of fact, in our firm, and I say this only because of the fact that we do have a firm of sufficient size to permit, and I would not want to impose the same restrictions on smaller firms. We have three separate divisions in the firm: the audit, or attest division, audit and accounting, the tax department which is involved primarily in taxes, and we have our management advisory services department of which I am the Western Regional Coordinator and of which Mr. Green is the National Director, and yes, we do have those separations. All of us have come through the attest function to become partners in the firm, to become

CPAs and have had considerable experience in the audit function. I dare say that our management advisory services have given us a much broader insight into the problems and the opportunities to perform a better audit as a result of management advisory services than would otherwise be the case.

PROFESSOR CARY: What is the size of your firm in terms of professionals?

MR. GREEN: We have at the present time in the United States about 600 professional staff. Overseas I don't know. It is more like another thousand, I think, over the world.

PROFESSOR CARY: If you were to identify your role in the field of management advisory services, how many of the areas would it cover that are referred to in the notice here including marketing consulting, plant layout, product design and executive recruiting, insurance actuarial services, employee benefit and so forth? How many of those would it cover?

MR. GREEN: The main impact on our practice would be in the marketing research area specifically. It would cover others to a less degree. For example, executive recruiting--like many firms we don't have a large department doing it, but we certainly don't want to be denied the opportunity of assisting our clients in seeking executives.

There is an important thing that we bring out in our written brief regarding market research. It struck us as curious that there was no suggestion of proscribing what are commonly known as economic feasibility studies of which we undertake a great many. In so doing over the years that we have been doing them, we have grown more and more aware of the need for quite intensive market research in undertaking a satisfactory economic feasibility study. That can cover such things as attitude and behavioral studies

because all those things of that nature enter into the judgment regarding the success of a proposed venture about which an economic feasibility study is to be written.

It struck us as curious that some aspects of those market research questions were not considered to be suitable for CPAs to undertake, whereas the way we look at it, we think it is absolutely essential that many of them do be undertaken, and we firmly believe that we should undertake them in-house rather than relying on outside authorities to give us the information that we should need any way in order to complete the study.

MR. WOOD: If you gave a client some brief recommendations on market research and they accepted your recommendations and they turned out badly and business was a flop, how would that affect your attest function?

MR. GREEN: I don't think it would affect our attest function. It might affect our pocketbooks very rapidly.

MR. WOOD. You answered the question as I thought you would. If you give some market research advice and it doesn't pan out as you hoped or as management hoped when they accepted your advice, I don't see how it would affect your independence as an auditor.

MR. GREEN: No, we don't think so.

MR. NOONAN: And more so, our advice is purely that, Mr. Wood. It is advice and recommendations, and in order for that advice to become reality and a fact of life, that advice has to be accepted, adopted and implemented by the client who then assumes the responsibility for it. We don't duck a responsibility for performing the service, but we certainly don't assume, and the client recognizes this, that we do

not assume or assure a guarantee that the outcome will be as projected.

MR. GARRETT: You wouldn't imagine there being any temptation to cooperate in making it look a little better?

MR. NOONAN: Oh, it never crossed our minds that such a thing could happen.

MR. GREEN: Those of you who are familiar with the internal working of accounting firms, I can assure you there is a pretty strong independence of thought, particularly differences of opinion, among the audit partners and the MAS partners on many occasions, but the thought of a compromise, no.

MR. GARRETT: They wouldn't be that eager to make you look good?

MR. GREEN: No, I think they really wouldn't.

MR. NOONAN: It might be just the contrary.
(Laughter)

MR. MATUSIAK: For a non-audit client, because of your expertise in the hospitality industry, would you accept an assignment which was quasi-management in nature for a non-audit client?

MR. NOONAN: Oh, yes, we do it regularly. In fact, for clients who are non-audit clients of any firm who are seeking an objective determination as to the potential success of a project that they envision, they have in mind a certain project, and they say: "Would this succeed under these circumstances in this place?" And they will come to us.

MR. MATUSIAK: You provide manpower then to perform the management function.

MR. NOONAN: No, no.

MR. GREEN: I think perhaps there has been a misunderstanding of your question. We undertake management advisory service work for non-audit clients, but not if we would not be independent. We would not

undertake a study if, in fact, we were going to become the managers. We do not become managers.

MR. NOONAN: Oh, no. In no instance would we be involved in the implementation of those recommendations or the supervision of construction or management of a project, no.

MR. McCLOY: Roughly, how many of your clients are SEC registered?

MR. GREEN: Some 35. We are not heavily involved in SEC clients. In the other hand, our SEC clients are very important to us. We certainly intend to maintain a position in the SEC Section of the AICPA.

MR. McCLOY: What other countries is your firm involved in besides England?

MR. GREEN: We have offices in many parts of the world, particularly in Africa, the Caribbean, all over Europe.

MR. NOONAN: Australia, New Zealand, Canada.

MR. GREEN: And that does raise an important issue really in our international practice, the consistency with which we can approach work.

MR. GARRETT: Are there no similar restrictions in the British practice?

MR. GREEN: No.

MR. GARRETT: Maybe your lawyer wouldn't want you to answer this too accurately, but would you read the Executive Committee's proposals as it applied to you making a severe dent in the MAS that you now supply, requiring you to give up some services that you now provide?

MR. NOONAN: I really could answer that no. But we still feel so strongly about any attempt at proscription on the profession as a whole that we feel forced to speak even though we might be affected very slightly.

MR. GARRETT: I see. Thank you very much

MR. NOONAN: Thank you.

MR. GARRETT: Mr. Auerbach. Please proceed.

MR. NORMAN E. AUERBACH: I am Chairman of Coopers & Lybrand. May I personally congratulate you and your staff for the very excellent discussion draft and issue identification document that you released in preparation for these hearings.

MR. GARRETT: Thank you.

MR. AUERBACH: I am, however, concerned with the degree of focus on the particular issues that we are discussing here today.

To state it very simply, I believe all our efforts and concentration toward improvement must be directed to the basic reasons for the public's concern over the certified public accountant's performance. The prevention of audit failures is the first problem. The second problem is keeping pace with the public's expanding expectations relative to the auditor's responsibility.

Analysis of the failures leads one to certain positive conclusions: First, the causes were primarily failures in judgment in the auditing area, much more than in the accounting area. Most often, the failure to recognize the significance of certain events or weaknesses that in one way or another were revealed to the CPA during the course of his work. The analysis leads you down a certain path--we must have good quality control in the firm, our people must be well trained, and above all we must understand our client's business. I would emphasize, we must have on board the special competencies necessary to deal with specialized areas such as computers, inventories, pensions, taxes, et cetera.

We are in a world of increasing sophistication and complexity. To think in terms of arbitrarily limiting the competencies in the current environment

would be like Bud Wilkinson, the new coach of the St. Louis Cardinals Football Team, deciding he is going to compete with the other teams in the league but stick to the old single platoon of his college coaching days--no two platoon concept, no special defense team, no special place kicker, no special punter, no kickoff team or kick return team, no special line coaches, no defensive coaches, et cetera. How would he do? And more interestingly, what would the public's perception of his team be when they lose 16 straight games, which they would do.

MR. McCLOY: It would change if he won 16.

(Laughter)

MR. AUERBACH: Gentlemen, in a period when we auditors are being challenged to step up to ever-broadening responsibilities, in the detection of fraud and irregularities, in the internal accounting control aspects of the Foreign Corrupt Practices Act, in the whole area of performance auditing as it breaks ground in the government area, how can we conceive of taking steps to limit the talent available to us?

One fact also comes through very clearly, and it has been repeated many times. There is no evidence that performing management consulting services has in any instance been shown to have contributed to an audit failure; to the contrary, I would speculate that the performance of such services and the broader knowledge base which it provides to the auditor and the greater skills available to deal with problems have contributed to the prevention of failures.

As the Chairman of my firm, I also believe that we must be responsive to the needs of those we serve. We are in a service profession and have been for 80 years. In that period, we have performed management consulting services for our clients,

admittedly organized more formally today than before. In the same way that the small accountant provides an ongoing consulting capability to his clients, so must the larger firm be responsive. Coopers & Lybrand has also performed actuarial services for almost two decades. We have twenty-three actuarial partners and a total staff of over 250 persons, with 52 members or associates of the Society of Actuaries. We have a volume of approximately 9 million dollars in this particular area.

MR. McCLOY: Actuarial area?

MR. AUERBACH: Actuarial area. We are professionally competent, have never had any public criticisms or lawsuits involving our performance, and have been most helpful to our audit staff in an area of ever-increasing concern to the public, namely, the pension liability, a concern in both the public and private sector.

In exploring the area of responsiveness, I would like to take a few moments to discuss an area in which there has been much flag waving, although I am not sure it is very important when compared to the focus which it has received. That is Executive Search.

How does one get into executive search? Does one do it for the opportunity of great financial rewards? The answer is no. It comes about as a result of a desire to serve.

Our clients know we have an appreciation of their needs. They also know that some of our professionals in public accounting want to go into the private sector. In sum, our clients recognize our general knowledge of the marketplace and so they seek us out. At first we responded by asking someone in the personnel department to see if they could help our clients out, or the partner or the manager himself

would scurry around and see if he could provide some help to their clients.

We finally concluded that we cannot and should not accommodate this need in less than a professionally competent way, so we hired professional search people who could capably match the needs of our client with the qualifications of the candidate. Were we trying to take over the search function in the country? Hardly. There are about 25,000 search persons in the United States, and our strategically placed professional staff never exceeded ten in this country.

The principal issue is independence, in the sense that the candidate placed would favor us as auditors if he were in a financial position. I say we must deal with that issue in the only way we can; that is, with an independent audit committee.

There is also a concern that we would later cover up for the employee on the theory that our being involved in his employment constituted vouching for his capabilities. You are, of course, aware that a search firm generally presents three candidates for a position, from which the company selects one; so we don't make an actual selection or the recommendation of a particular person.

What is more interesting is the current idea that auditors should be prepared to respond to audit committees when asked their evaluation of the competency of the financial management of a company, and this notion is included in a proposed SEC release. Are we auditors to be precluded from giving such views on the competency of a client's employee on the basis that once having given such an opinion, we would not be independent thereafter with respect to that man because we had already made a representation? I doubt whether we could so behave in today's environment.

Executive search is not really a gig issue. I don't think it should ever have been proscribed. We shouldn't retrogress to doing this job in less than a highly professional manner; and I am fearful with proscription that is what the result will be.

Gentlemen, we have submitted a detailed paper to the Board. My objective here is not to read or attempt to cover that paper, since I am sure it will become part of the record and you will have an opportunity to focus on it.

I would like to just very briefly deal with the six key questions which you asked.

We must agree that independence is a fundamental issue, and we believe it is the only key issue bearing on scope of practice.

On the question of the appearance of independence, I find no factual evidence that audits have been compromised; and as I indicated earlier, the contrary is probably the case. I believe that a strong audit committee focusing on the relationship with the auditor can assure the public that the relationship is a beneficial one to the stockholders and that they, being in the best position to judge, are satisfied as to the auditor's independence. You will never deal effectively with the appearance issue until we have the auditor retained by an accountable to the audit committee, not the management, even though we understand that there must be a good working relationship with management if an effective audit is to be conducted.

The sole test, other than independence, is that the service performed in a professional manner with highly qualified personnel, provides meaningful benefits to our clients, and is supportive and not disruptive to the performance of the attest function.

I think there should be no arbitrary limits

to the scope of our consulting practice. It must be responsive to a need, obviously, and if it broadens our abilities to better understand our client's business, and if a committee of independent outside directors is in agreement that it does not affect our independence, the client and the public will ultimately benefit. Our own good business judgment, and I want to emphasize this--our own good business judgment and our consciousness as to how the market views us and the importance of that perception will act as an appropriate governor on what we choose to do.

The effect on the business community of performing a needed service in a highly professional manner can only be positive. Our proximity and familiarity with the business and its operations, the fact that we continue on the scene, affords us the unique opportunity to be constructive in a cost effective, and reasonably undisruptive manner.

A proscription of advisory services would, if one looks to the nature and character of the advice given, probably hurt the small accounting firm in a fairly significant way. The smaller firm takes pride in its hand holding, continuous type of business consulting. This service is needed, and it should be permitted to continue. The larger firms practicing management consulting are involved in the more complex, sophisticated areas, but then so are their clients.

I prefer not to draw a distinction between tax and other advisory services, although we are all aware that one can do nothing in the area of accounting that doesn't carry with it tax ramifications. To force any kind of separation between tax and audit practice would be cost

prohibitive, particularly to smaller companies. The impact of any proscription on small firms would, in my view, be devastating and clearly against the public interest.

MR. McCLOY: How about a proscription on taxing?

MR. AUERBACH: That's right. Let's analyze the arguments for restricting service, not necessarily in the order of importance. The first argument is generally advanced by the regulators and goes something like this: the auditing profession owes its growth and strength to the various Securities Acts and their amendments. Therefore, the sole reason for the existence of the profession is the Securities Act.

This simply is not so. Coopers & Lybrand has been in existence for 80 years, long before the Securities Acts came into existence; and over these years, we have performed many valuable services for our clients in response to their needs. Furthermore, regulation is not the only means of accomplishing social objectives. I believe that private enterprise would have found a substitute for the securities laws to mandate reliable financial reporting.

If we examine operations in other countries, we find that indeed alternative approaches, relying on the services of the independent accountant, have developed and are flourishing. The regulatory argument tends to fall of its own weight.

A second argument is that an auditor, in furnishing management consulting services, somehow becomes inextricably involved in the client's actual decision making, thereby undermining the objectivity critical to the exercise of the attest function. This is an invalid argument for two reasons: To

begin with, our consultants, as a matter of principle and practice, do not make management decisions. Second, the argument runs contrary to human nature itself. Management decisions are made by those who have the responsibility to act. A highly placed executive is not willing to turn over to a consultant the responsibility to make decisions that he himself is responsible for.

The third argument has been tendered, namely, that providing some types of non-audit services places firms in the position of auditing their own work. This question would arise, for an example, if an auditing firm were engaged to derive, actuarially, the amount of the contribution a client should make to its pension fund. Given this view, the fact that the auditing firm's staff made the original calculation would somehow deprive it of the auditor's "second look" if the amounts were used in preparing the financial statements. I would like to expand a little bit on this particular subject because I think it is important.

Let me try and explain some of the issues that relate to the concept of self-auditing. In today's environment, the independent auditor often uses the skills of other experts--for example: an appraiser, an attorney or an engineer--to provide sufficient, competent evidential matter to afford a basis for the auditor's opinion regarding financial statements.

What is the auditor required to do on those occasions when he has used the work of other experts? Must he audit the work, or can he use it without attempting to apply procedures that go beyond the other experts' report? The truth is that the auditor takes a course which avoids both extremes. Under today's requirements the auditor's education and experience enable him to be knowledgeable about

business affairs in general, but he is not expected to have the expertise of a person trained for, or qualified to engage in the practice of, another profession. Thus, the procedure that the auditor applies to the report of a specialist is limited to obtaining an understanding of the qualifications of the specialist and his relationship, if any, with the client, and an understanding of the scope of the specialist's work, since it will form the basis of a representation in the financial statements. When the auditor uses the work of a specialist, he has no duty to go further unless he has reason to believe that the specialist's findings were reasonable in the circumstances. Under these rules, the auditor can appropriately use the work in the same way as the auditor would examine the client's other computations or calculations. Because we think independence from the client is critical, we apply special rules when the specialist is related to the client.

Under the present rules, the auditor is prohibited from making reference to the fact that he has used the work of another expert in conducting his examination. I personally feel that this restriction should be changed, and I believe that my view is supported by the findings of the Cohen Commission. I think if it were made clear that we often to rely on the work of experts and that we do not audit their work, there would be less concern about the position of the actuary whose work is treated in this way.

There is another way in which the auditor could deal with the work of a specialist. That it, he could audit the work of each expert as he audits any other bit of evidence which he obtains from the enterprise's management. A decision to move in

this direction would inevitably increase the reliability of the related financial statements. What is the old saying? Two heads are better than one. We would have two performances of the same task. It would also, however, also increase substantially the cost of the auditor's examination. Take, for example, the work of the geologist on which the auditor relies. If that work has to be redone in the case of every oil company in determining its reserves, the cost would be significant. The fundamental question that remains is: Is the expected increase in reliability of financial statements sufficient to justify the additional costs that would be imposed on the enterprise and ultimately on the shareholders and consumers of its products?

In reaching its decision regarding treatment of the work of a specialist, the accounting profession recognized that the auditor's existing "social contract" mandates that increases in audit costs should be forced on American business only when it can be clearly shown that there will be appropriate benefits.

Some of those who have explored the areas of self-audit have not faced the problem squarely, but perhaps they have not properly identified it. The real issue is: Can the work of actuaries be treated in the same way as the work of other non-audit specialists; or, stated differently, can the work of an actuary be distinguished from the work of other specialists, for example, the appraiser, the attorney or the engineer?

I don't think they can be or should be distinguished. I think the actuaries do comprise a professional group. They, through their various organizations, have begun the work of establishing

the framework of self-regulation. Just as the auditor deals with measuring the financial impact of completed transactions, the actuary deals with the measurement of financial implications of expected transactions. I share with them their keen desire for full recognition in the family of professionals. To single out the actuary's work for treatment different from the work of other specialists--appraisers, attorneys, engineers--whose work we do rely upon, would, in my view, be an error. In this respect, the self-audit issue is not a real issue as it related to the actuaries. I believe the Cohen Commission's report implicitly supports my view. The Commission further suggested that, as a preventive measure, the auditor's standard of care be extended when he uses a specialist who is an employee of his firm. We accept this concept, because we believe that the same high standard of care that prevails in the auditing environment should be extended, can be extended, and is being extended to every professional service that my firm offers.

When we, as Coopers & Lybrand, are involved as the actuary, we take on a substantial responsibility, because we are now responsible for the work of the expert as well. From the point of view of the protection of the public, we can't get off the hook by a statement that we were relying on the work of an expert to whom we are not related and to whom we attribute the failure if there has been a failure. We are on the hook, and therefore, from the point of view of the public's protection, the public is afforded even greater protection perhaps than they might otherwise be.

On the subject of competition, some

contend that accounting firms offering a broad spectrum of non-audit services are waging unfair competition with other companies offering similar services. I just don't believe that to be the case. We are competing with others and the competition is healthy. Our clients and the business world are fairly sophisticated when it comes to consulting services, and that is an area that has become very competitive. It is very unusual in today's environment that the company will limit the proposal opportunity to its accountants and auditors.

Competition is healthy. The ultimate beneficiaries are the stockholders in American enterprises. There is no reason to believe that the results of competition in this area would differ and have any other effect than from competition in any other field.

Some of the areas under discussion here, such as actuarial services, have long been associated with accounting. We consider ourselves co-professionals with actuaries, and we have had many important links with them. This is so since the auditor, as I said before, may be said to be the primary examiner of the current financial implications of past events while the actuary measures the current financial implications of future events. We are both very much in the financial business of dealing with figures. There is a close relationship. One of the earliest professional institutions in the world was the Accountants and Actuaries in Scotland, under that very name; and Coopers & Lybrand, as I have indicated, has offered actuarial services for almost two decades.

Gentlemen, we do compete. We compete with actuaries, we compete with other management consultants, and we even compete rather aggressively

with other accounting firms. I think this competition is appropriate and desirable.

There is no logical or ethical reason to force us to divest ourselves of any part of our consulting practice. Our standards are vital and rigorous. Our auditors benefit by the association with experts from other disciplines and thus broaden their own capabilities.

My last comment, gentlemen, an important point which cannot be ignored, is the influence that the breadth of our practice has had on entrants into our profession. The green eyeshade days are gone, and the young people sense it. The diversity of problems, the alternative career paths, the opportunity to contribute to the profitability and effectiveness of American business are bringing to us better young people than ever before. With proper training and proper quality controls, the contribution of our profession will be significant because we are a people's business; the better we are, and the more talent we possess, the better shall the public be served.

Thank you.

MR. GARRETT: Thank you, Mr. Auerbach.

Are there questions? Mr. Wood.

MR. WOOD: I don't have any.

MR. STARK: I have one. Do you agree with the restrictions that are suggested in the Executive Committee's proposal with respect to actuarial services, and would the application of those restrictions have an impact on your firm?

MR. AUERBACH: I don't agree with the restrictions; and yes, they would have an effect. I can't give you the exact financial effect that the particular revisions relating to insurance work would have, but we do have a number of people

involved in that area.

We don't agree with the insurance work restrictions. We recognize, of course, that the rules are established by the majority of the Executive Committee.

MR. STARK: In the pension benefit area, you would continue to be able to function?

MR. AUERBACH: We would be able to under the proposed rules.

MR. WOOD: In those firms, insurance companies that you audit, and for whom you provide actuarial service, is there in every case an in-house actuary or an in-house actuarial staff?

MR. AUERBACH: I don't know, so I couldn't give you an answer whether in every case there is. The way we function with management however does not depend on whether they have an actuary or not. They are fully aware both how we propose to deal with a particular matter, and what we propose to do. When we present our recommendations, management is then able to adopt an approach that they believe is sound. As auditors, we have to be satisfied, of course, that the approach adopted is professionally satisfactory to us.

MR. WOOD: If you were auditing an insurance company and did not provide actuarial service, you indicated in your remarks you would rely completely on the actuarial service of a professional actuary that served that insurance company.

MR. AUERBACH: I didn't say that we rely completely on it. I think, as a matter of fact, the existence of consulting actuaries within our firm has made our auditors a little more astute in respect of the appropriate questions to ask, particularly when we use the work of non-independent

in-house actuaries. I think we are even just a little better at asking the right kind of questions when we are dealing with independent experts, and we do recognize that under SAS-11 we rely on the work of these experts.

MR. WOOD: You go beyond reliance then and you pose some questions.

MR. AUERBACH: We are required to make certain inquiries and we use the knowledge and capability which resides in the firm.

MR. MANZONI: Has that resulted in some specific improvements?

MR. AUERBACH: Improvements in?

MR. MANZONI: Improvements in financial statements.

MR. AUERBACH: It is very hard to give you specific instances where this competency has resulted in a better end result. We feel, however, that this has been the effect, particularly in the case of pensions.

MR. MANZONI: If you were the actuary in that instance, though, you wouldn't have that "second look," even though the second look isn't required, as I understand it, under the standards.

MR. AUERBACH: In a sense we do have a second look. We get this through the quality control procedures within the actuarial group itself. We satisfy ourselves that reviews have taken place by two accredited professionals during the engagement and that we can feel comfortable, recognizing the exposure of the firm.

MR. MANZONI: Would that be the same person that made the determination in the first place?

MR. AUERBACH: A different person.

MR. McCLOY: Do you accept the fact that today the public is somewhat skeptical of the

reliability of the accounting profession?

Is there something that this Board should be doing something about trying to improve the credibility of the attest feature of the accountants, or is this something that you just let the marketplace deal with?

MR. AUERBACH: Oh, no, no, I think there is a lot to be done in the area of credibility, and I think you gentlemen, as part of your responsibility, are going to be focusing on what I think are the key areas--the areas of quality control and peer review, the quality of the work that is being done, and whether you are satisfied with the steps being taken to maintain quality.

MR. McCLOY: Audit committees and so forth.

MR. AUERBACH: Audit committees, the whole bit. This is the crucial area. What we are talking about here is important only because as business gets more and more sophisticated, we can be better auditors to the extent we have greater competencies available to us that we can draw upon--and we do draw upon them.

When you get specialized problems and difficult inventory situations, we draw on our experts who are better equipped to deal with them. Certainly the computer--I don't need to go into that--has been the best example where sophistication is required; and the development of the auditing process, through the computer and the security that is required surrounding the computer is such that special capabilities are a must.

MR. McCLOY: But you wouldn't think that a proscription would help. You know, you set up a rule sometimes, and you have to wonder after you have set it up, and the exception then becomes the rule. I think the key test is that there is a benefit going to the client, that you are qualified to do the

service, and that you are satisfied that it doesn't disrupt or undermine your ability to be effective in the attest function.

MR. McCLOY: I am sure that is entirely a subjective test.

MR. AUERBACH: It is a subjective test, but we are business people and I think we are pretty good at applying that test.

MR. McCLOY: But you have a public responsibility.

MR. AUERBACH: I think part of your function of peer review and the other examinations of our performance is to look for any evidence that we have done anything to improperly impact on the public. That would be very much a part of what any peer review performance would entail.

MR. McCLOY: I have this feeling--I am just thinking aloud here because we are just new in this abstruse question--that you fellows have been dealing with, I am told, for the last 10 years. There is sort of the feeling, I think, around that you are into everything that comes along, no matter. Anything that will turn over another dollar, that you are sort of a jack of all trades and master of none. You don't have the professional focus that you ought to have in order to maintain your reputation as objective.

MR. AUERBACH: But that is speculation. It actually hasn't happened that way. We talk of executive search, and that gets played up, but I tried to explain to you how we get into that. It is not a dramatic thing. It is really very, very small, just trying to respond to a need.

We don't do any plant layout. I have been trying to find the accounting firm that does plant layout work, and yet I see in every bit of

writing there's plant layout all over the place.

I see these things, but they are not significant. Maybe in one instance somebody had a situation and said: "Well, if you changed the plant over there, maybe the paper flow would be better." I don't know. Maybe that is plant layout work. But I am just saying that I don't know of any significant area that we are involved in, that my firm is involved in, that is not handled in a fully professional way. No service that we provide could cause any emvarrassment to the profession, or doesn't make good sense for us to be in, or would not be easily understood by any one examining what we do. I say that as long as we have the appropriately qualified people it is appropriate for us to provide that service to clients.

MR. McCLOY: You are aware that the Congress is very skeptical about this.

MR. AUERBACH: I am very much aware of what Congress has done. I am also very much aware that Congress came to the conclusions before they made the study. (Laughter)

MR. McCLOY: They came to the conclusion before we came onto the grounds. But we are reaching out to find out what the situation really needs at this time in order to restore confidence.

MR. AUERBACH: I get a little troubled frankly, when people talk in terms of confidence. I don't find as I deal with the business world that businessmen are any less confident in us today that 5 years ago. I will have to tell you I think they are a lot more confident. They think we are a lot tougher, perhaps they wish we weren't so tough. I think generally the confidence level in what we are doing in the attest area is higher that it has every been.

I think the perception as to whether or not confidence has eroded is coming initially from the Congressman who says: "You have got to do something about an Equity Funding." Everyone is upset because there have been failures. There will continue to be some failures because we are in a people business, and there will be judgmental mistakes. Our job is to minimize them.

The important thing is not to try to narrow the capabilities that reside in the firms. We must try to satisfy ourselves that we have the control procedures within the firm, the checks and the balances, to be satisfied that we are giving the greatest protection to the stockholders. That is the key, and to the extent that we can minimize the failures, the confidence level will go up.

MR. McCLOY: Keep your eye on the third party suits, too.

MR. AUERBACH: Absolutely. They are beginning to bother us more than ever.

PROFESSOR CARY: I have two questions. One, you have emphasized, as many of the large firms and others, how much the proscription would hurt the smaller firms.

Accepting the premise that there would be some proscriptions, do you think you could differentiate and say they should not apply to small firms?

MR. AUERBACH: The problem becomes one of the ease with which you can define what is being done. When the smaller firm provides consultation to a client, it is on a very broad, informal ongoing kind of basis. We set up a separate department, and we begin to identify the particular departments that provide specific management consulting services. When you proscribe any service for a big firm, I

don't think you could say that a small firm can perform the same service in respect of a public client. I just don't think you can differentiate that way, because then you get to the problem of at what point does one become big and at what point is he small.

I think the biggest problem is one of defining what it is that the small accountant does. I can tell you what the tendency will be. The tendency will be to pretty much ignore what the small firm does in the sense of not bothering with them, and maybe from the public point of view that is all right.

I am trying to give you the practice answer even with respect to proscription. I think the likelihood is that there won't be too much bothering with the small firms.

PROFESSOR CARY: The other question I had was the one I asked Mr. Vanatta, and I am going to ask every major firm that is very widely involved.

What is your reaction to proposals of merger with Booz, Allen and McKinsey and major geological engineering firms or what-have-you?

MR. AUERBACH: I know one thing. The lawyers won't let us alone.

I would say again that you have to examine each situation.

If, for example, we were to get involved very much in replacement costs or fair values and some of the similar determinations, and the accountants are asked to take responsibility for some of the evaluations that are going to go into financial statements, somebody might convince me that maybe I ought to have some appraisal competency within the firm.

PROFESSOR CARY: This may come.

MR. AUERBACH: It may come, and I say let's not try to decide right now what is appropriate. I think when the circumstances come up, if one concludes that it makes sense from the point of view of being responsive to a need and consistent with the responsibility you are being asked to assume, we may decide we need a new kind of competency on board that is going to make us comfortable. So I say, I would want to deal with it in the circumstances when the situation or the responsibility is presented to us. Then I want to say: How do I best respond and deal with it?

MR. GARRETT: Norm, isn't there any need to preserve some proportion in such situations? I mean, is there any danger in the attest function, of the auditing becoming ancillary to the sale of some other service?

MR. AUERBACH: I would say the likelihood of that is very slim. I happen to believe that the profession is on the threshold of tremendous expansion in the auditing function, and I look particularly at the government area because I think that is where it will come first.

The GAO is sort of leading the way in getting involved in performance auditing. That is, the auditing of government expenditures not from the point of view of the accountability for the dollar spent, but whether the purpose of the expenditure as identified and prescribed was ever achieved.

More and more, auditing is taking on a perspective that is much broader than we here are trying to define. I think we have to respect the fact that this is coming, and as one gets involved in performance auditing you will need special

competencies just as the GAO draws upon many competencies to perform what it considers to be a very important auditing task.

We are not there yet, and we are certainly not there in the private sector, but in the government sector we are going to see it, and it is going to come soon.

MR. GARRETT: So you are saying even if it might be an evil for the audit function to be a sort of throw in, along with the sale of other services, the practical likelihood of that occurring is so remote that we don't have to worry about it.

MR. AUERBACH: It is very remote, very remote.

PROFESSOR CARY: What you are saying really is the attest function may become much broader. Is that it?

MR. AUERBACH: That is correct. I do believe that.

PROFESSOR CARY: On that premise, then, you need persons on your staff to analyze performance in a broad way.

MR. AUERBACH: In a broad way. I think that is true.

PROFESSOR CARY: That has not yet been quite clearly articulated by anybody before, and I just think it is an interesting thing.

Is the accounting profession, as a whole, your Big Eight, for example, are you pushing toward a performance audit?

MR. AUERBACH: I will be honest with you. The last thing the private sector would want--I am talking about American industry--is to have the auditors go around pushing for the opportunity to opine in respect of their performance from that point of view. I am not running after that. (Laughter) But in

the government area, I think is the area in which you have an entirely different situation.

You have got that third party out there, the public, who is very interested. And they are going to look to the accountants, and the GAO is not going to be able to do it for the whole country, not at the state and local level. They do it to a degree at the national level, and even there they are not competent, or capable, or big enough.

MR. WOOD: There is one big difference that Congress can't fire the fellow who is wasting the money; we can in business, and the accountability factor in the private enterprise and the government are just two totally different things.

MR. AUERBACH: Two different worlds, and I respect that. That is why I say I think the avenue and the direction come from the government area, and there it is important.

MR. WOOD: I just want to slow down my friend, Bill Cary.

PROFESSOR CARY: Their premise is performance, and if they start with that, then they say because performance is gaining, therefore, we need all this variety of skills, so I am trying to get down to their logic because I am not for it at all.

MR. GARRETT: What we really need is the legal audit, Bill, you know that. (Laughter)

MR. WOOD: Back to the actuarial services, are we really talking about MAS or MS when you are providing actuarial services: Is it advisory service?

MR. AUERBACH: Sure.

MR. WOOD: Or isn't it management service?

MR. AUERBACH: No.

MR. WOOD: You go and tell an insurance company what its reserves ought to be on either casualty and liability claims or on life. Isn't that

a management service?

MR. AUERBACH: No, I think I draw a distinction in the sense that you will discuss with management the approach to the determination of the figure, and they will come to an agreement, but overriding that is the profession judgment which you, as a professional, have to exercise that you are satisfied with the conclusion that has been reached. There is a difference.

MR. WOOD: Thank you.

MR. GARRETT: Finally, would you associate yourselves with Mr. Vanatta's recommendation that the peer review expressly include some examination of the role played in the performance of management advisory services?

MR. AUERBACH: I would have no problem with that at all.

MR. GARRETT: You would agree that the role could be such as to impair independence?

MR. AUERBACH: I don't quite--

MR. GARRETT: All right. The role is the term that one of the other speakers used in this, I guess Mr. Arnstein, in this respect, but that management advisory services could become what Mr. Wood was talking about. That is, participation in management or operation.

MR. AUERBACH: I think as a matter of policy, we as a firm are very careful--

MR. GARRETT: I am sure you are.

MR. AUERBACH: --that management services don't become

MR. GARRETT: The suggestion was that that is a danger area and peer review should look into it.

MR. AUERBACH: I have no problem with peer review looking into it. I am comfortable as to what they would conclude.

MR. GARRETT: Very good.

We are only a half hour late the first half
day.

Should we take an hour for lunch and convene
at 1:30?

(The hearing recessed at 12:30 o'clock.)

THURSDAY AFTERNOON SESSION

August 17, 1978

The hearing reconvened at 1:40 o'clock with Mr. Garrett presiding.

MR. GARRETT: May we come to order, please.

There are several that are interested in the transcripts, and what is going to be in them. You should know that people that have made statements will be given an opportunity to correct the first copy of the transcript before the official transcript is finally settled upon.

Mr. Keating, will you please proceed.

MR. RICHARD C. KEATING: My name is Richard Keating. I am an officer of A. S. Hansen, Inc. A. S. Hansen is a consulting firm with approximately 500 employees operating out of 22 offices. We provide actuarial services to about 3,000 pension plans most of which are subject to the provisions of the Employees Retirement Income Security Act of 1974.

We have previously submitted written comments to the Securities and Exchange Commission in which we asserted that there was a self audit involved in a CPA firm providing actuarial services to its audit clients which could present a conflict of interest and a threat to independence. In the comments we quoted certain luminaries within the accounting profession who held the same view.

There has been public concern about the management advisory services provided by some CPA firms. This concern has been expressed by individuals, by the media, and in the Halls of Congress. Evidently the concern has been serious enough and broad enough to provoke these hearings.

My purpose today is not to repeat what we have said but to comment on some of the reason or

rationalization that has been put forth by persons who would put no restrictions on the activity of CPA firms, or at least no restrictions on what they are presently doing.

An argument is that there is no hard evidence of an audit being impaired by advisory activity. What this means is that if impairment has occurred we don't know about it. An audit impairment or a lack of independence is not something we would ordinarily find out about. It could be extremely subtle. It would have to be dug out. Is it necessary to wait for a scandal?

I believe that most businessmen, and especially most businessmen charged with the administration of pension plans, are honest. I believe that most auditors are honest and ethical and competent. I believe that most actuaries are honest and ethical and competent. The point is that not all are--or we don't know that all are. Even if there has been no impropriety there is opportunity for impropriety. Hence the role and reason for being of the auditor.

What we have here is the old theological concept of the proximate occasion of sin. In the old theology this is something to be avoided.

If we consider a firm offering the whole panoply of MAS being offered by CPA firms (not all by any one firm), where for a client the firm has been involved in the recruitment of managers, design of systems, actuarial valuations, marketing service, etc., and then auditing the client we cannot picture Ceasar's wife as the managing partner of such a firm. For public acceptance, the appearance of independence must be preserved.

There is the argument that the services are in the public interest, that they can be provided

with competence and efficiency. For some services this may be true. But for many services the offering of such service is not filling a social void. It is purely an expansion and diversification. The service is already being provided competently and efficiently through other sources.

In the actuarial realm, there is the argument of the close interrelationship of accounting and actuarial work, that they are logical extensions of one another. I won't go into that because I have reason to believe that that will be discussed further in subsequent testimony.

With respect to actuarial service it is argued that the provision of such service is proper provided that management understands the principles and implications of all that is involved. In the general case such understanding simply doesn't exist. To assume that it exists in a particular case is highly questionable.

In my practice I frequently attempt to explain to management the principles and methods going into pension costs; not because I have to but I think I ought to.

At times I bring a lecture to a quick end because I realize the client doesn't want to be bothered. He has other things to do. The question also arises as to what is management. If some middle manager understands, this is not Management.

On pages 22 and 23 of the Notice of these hearings are listed the Employee Benefit Consulting Services that an audit firm may properly do.

These services impinge heavily on the legal area as well as the actuarial.

The list depends upon the concepts that actuarial service for pension plans is something that one can do from time to time and then walk

away from, and that management is responsible for actuarial determinations. Both of these concepts became obsolete in September of 1974. It seems to me that the actuary in presenting his work has to assume the responsibility or at least significantly share in the responsibility. Under ERISA the position of the enrolled actuary is a continuing one--even to the point that if the sponsor or administrator changes the enrolled actuary he must give a reason. A main point of ERISA is to take away from management the right and responsibility of making actuarial determinations for pension plans. There had been alleged, and some real, abuses that the Reform Act was supposed to take care of.

I appreciate the fact that the concern of the SEC is the provision of information to investors and shareholders. However, any policy and rules must be embedded in a larger social context. Part of this social context is the law of the land. Overlooking pieces of this can cause confusion to shareholders as well as plan participants and the general public. I also realize that it is presently not necessary to report to shareholders the same actuarial numbers as are embodied in the ERISA Funding Standard Account. However, it seems clear from Committee Report that concordance in reporting was the intent of Congress. Shareholders can also be plan participants. Conflicting and confusing numbers can only lead to more reform legislation.

I thank you for the opportunity to present this statement.

MR. KEATING: Are there any questions?

MR. GARRETT: Mr. McCloy.

MR. McCLOY: The first item you referred to was the self-review, I believe. There are a

number of services which accountants render. I suppose the chief example is the tax situation, the tax area.

There seems to be very little, at least as far as I can understand, objection at this stage of our history to accountants becoming involved in the income tax situation, the preparation of returns and what-not.

To the extent they engage in that tax service, aren't all accountants self-reviewing their own work when they take into account the work of their tax service, the effects of their tax service and the attest that they make?

MR. KEATING: I am not an expert in tax service. I am not really cognizant with all that is involved in this. I think as with other services, there is some possibility of self-review.

MR. McCLOY: I just say self-review per se is not necessarily vicious or not necessarily an argument against permitting the MAS. I will just give the example of tax service. Maybe another example would be the computer services that they render.

To an extent, there is an element of self-review in areas whereby almost by common consent you have already said that the accountant should have freedom of action. So in itself it doesn't necessarily condemn the offering of such services by the accountants.

MR. KEATING: Self-review always in itself, to my mind, in any form, does to some degree interfere with the audit function.

MR. McCLOY: Would you say it is determinative?

MR. KEATING: That self-review is determinative?

MR. McCLOY: The fact that there is a self-review, once you find there is any element of self-review, would you then abolish, would you then

proscribe, any advisory service which has that element in it?

MR. KEATING: I think any service which has that element in it is questionable. Whether I would proscribe it or not? There are certain other issues involved.

You mentioned the tax service situation. It is entirely possible--I am not asserting that this is true--but it has been held that this is performing a social service, an essential service, that is filling a void, that the accountants are tax experts, and it is highly efficient that they perform this service.

That might be taken into consideration as one point, but to get back to your question, unless there are extreme safeguards involved, the concept of self-review is incompatible with audit.

MR. McCLOY: It isn't entirely so, is it, because there are a number of things that the auditors can do, or the accountants can do, or are accepted now as doing. No one really can object. You wouldn't go so far as to say no accountant could make out a return for a client anymore?

MR. KEATING: No.

MR. McCLOY: In the case of the tax return, isn't there some element of self-review?

I don't want to press the thing too far. What I am trying to get at is the most serious, the most important objection that the actuaries have to the furnishing of actuarial service by the accountant firm.

I just question whether the self-review element is the chief objection.

MR. KEATING: I believe it is. The accountant working, doing tax work for a client, he then does not turn around and audit that tax work. That is something entirely different.

MR. McCLOY: His work is such an important element in the accuracy or the fairness of the statement that he is in a sense reviewing, and I just wanted to get what the real gravamen, what the real substantial objection is on the part of the actuarial association. What is the chief defect in permitting the accountants who are retained, who are presumably as well equipped or reasonably well equipped as actuaries to do the work in connection with pension calculations and what-not.

MR. KEATING: I believe the primary thing is the self-audit.

PROFESSOR CARY: Just to rephrase Mr. McCloy's question, assume that the accountant certifies a balance sheet with a large tax liability. What is the difference between that and certification, or attestation with respect to a large pension liability on the balance sheet? Aren't they comparable in every way, in that in both these is the element of self-review?

MR. KEATING: You are saying that the accountant has done all the work in preparing this tax liability. He signs off and says this is, in fact, the case.

I think that in my response to Mr. McCloy, I believe that there could be a problem there in the interest of self-review.

PROFESSOR CARY: Equally.

MR. GARRETT: I understand your premise also to be that you think it more often than not, at least, that the accountant or auditor performing the actuarial function with respect to the pension plan would be, in fact, making the decision for management?

MR. KEATING: In fact, yes, he would be making the decision for management. There are certain rare circumstances that it might be otherwise, but by law the actuary is required under ERISA to make the decision with respect to actuarial assumptions, and

actuarial procedures. This falls upon the actuary, and it cannot be shifted off upon management.

MR. GARRETT: So that if the auditor is playing that role, the enrolled actuary for an ERISA plan, by law the decision is the auditor's and not management's. Is that right?

MR. KEATING: That is right. By law the decision, the responsibility, is the actuary's. The person is wearing two hats. He is wearing the actuary hat when he comes under the law.

MR. GARRETT: We didn't inquire of any of the auditing firm spokesmen this morning, but I gather from what you say that the auditors do play that role if they are offering actuarial service because they go so far as to become the enrolled actuary.

MR. KEATING: It is my understanding that it is the case that the employees of the auditing firm are the enrolled actuaries for certain plans, yes.

MR. GARRETT: If that is not true, I am sure we will be straightened out.

MR. KEATING: That is true.

MR. GARRETT: If there are some people that don't think it is true, I am sure we will hear about that, too.

MR. MANZONI: To what extent do auditors now question your actuarial determinations or review them?

MR. KEATING: Actually, they do not question our actuarial determinations to the point of arguing with us about them. I hope the treatment becomes a bit more uniform. We receive questionnaires from auditing firms. We receive lists of data that we are asked to check and respond. Is this what was actually used in the

calculation? The lists vary by firm and ask some very pointed questions.

First of all, is an enrolled actuary doing the job? What are his credentials and so forth? And then questions as to the method, procedure, assumptions.

We routinely answer these questions. We get further questions and we respond to them. What is done with all this information, I do not know, but there is a review typically with respect to the content of the figures we put out for funding a plan for ERISA or also for reporting to shareholders under the P & L.

MR. MANZONI: If auditing standards did not require auditors to do anything other than determine what your competence was and rely upon the work that you did as an expert, would you have any problem with auditors performing actuarial services?

In that context there doesn't seem to be any review, so consequently, there couldn't be any self-review. They just perform separate specialized service.

MR. KEATING: I think there is the self-review, or the danger, as I mentioned, of impropriety there.

MR. MANZONI: That presumes that they review you. What if the auditing standards didn't require an auditor to review the actuarial assumptions and determinations in the first place but simply to audit what the actuary did as an expert?

MR. McCLOY: They may rely on their own actuary in one case and they have relied on outsiders in the other.

MR. KEATING: We have the circumstance that in reliance on an expert the auditor, as I understand it, is supposed to satisfy himself with the competence at least of the expert and he is satisfying himself with the competence of his own expert.

MR. GARRETT: I believe that is it. Thank you very much, Mr. Keating. We appreciate your coming.

Next we have Mr. Boynton, Mr. Gustafson and Mr. Latto all for the American Academy of Actuaries.

Gentlemen, will you identify yourselves for the benefit of the Board.

MR. EDWIN F. BOYNTON: I am Mr. Boynton; to my right is Mr. Latta and to my left is Mr. Gustafson.

By way of background as individuals, Mr. Gustafson and I are officers of the Academy in a volunteer capacity. For the past twenty-five years I have been a pension consultant with a consulting firm. Mr. Gustafson's background is principally in life insurance and is Vice President and Actuary for a large mutual insurance company.

The Academy itself was formed in 1965 as an umbrella organization to bring together into one body the actuarial profession in the United States. There are presently about 4,500 members of the Academy, out of approximately 7,000 members of the four national actuarial organizations that are under the same Academy umbrella. The difference in numbers results from experience requirement to become a Member of the Academy.

That sounds like a small number compared to the American Institute of CPAs. It is, but it does represent a very substantial percentage of the qualified actuaries in the United States.

We have filed a rather lengthy written statement, and we have also prepared a summary statement. That is also too long to read, so I am going to try to summarize the summary.

In our principal statement, Part I sets forth our position that an independent audit cannot be conducted where some of the items in the financial statement being evaluated constitute or result from work performed originally by an actuary who is employed or affiliated with the auditor. It is the self-review question that you have heard so much about today.

In our written statement, we deal at some

length with the findings of the Cohen Commission. In this regard, and in Part II of our statement, we have discussed the practical application of the AICPA prohibition against the auditor effectively becoming part of management. We think the concept is a sound one, but the real question is in its application. It is evident to us that the central application of this concept means that whether you call a relationship advising, assisting or helping, the proper test is whether the actuary, in fact, repeatedly provides or takes a position on the recommendation that becomes part of the management decision. This does not mean, of course, that management should not obtain ongoing counsel. It is just we don't think we should obtain it from his independent CPA.

Part III starts from the premise, as stipulated in the proposal, that CPA firms in SEC practice would be limited to management advisory services that call for the use of accounting and auditing-related skills. We take no position as to whether such restrictions are necessary or desirable. If it is imposed, however, we believe the proposal is in error in asserting that accounting and actuarial skills are significantly related. We show in the third part of our statement that while there is some partial overlap in certain of the elementary subjects (introductory statistics and statistics) there is none at all in the much larger set of advanced subjects, the subjects that are critical to professional qualification. So the two skills, in fact, require almost totally different education and training and are not significantly related.

In Part IV we apply the concepts of self-review, management decision-making and related skills

to specific services that are listed in the insurance and employee benefit sections of the proposal.

I will comment first on self-review. It all boils down to the fact that it is difficult for us to conceive how it can be claimed that any firm could review its own work and assert that such review is independent. The position taken in the proposal is parallel to the position taken by the AICPA Ethics Committee in its accounting services interpretation of the independence requirement, and that interpretation has been rejected by the SEC as not meeting the independence requirement. The Commission stated its opinion that an accountant cannot objectively audit the books and records which he has maintained for a client, since it ultimately places the accountant in the position of evaluating and attesting to his own record keeping. We believe that principle should be extended to the provision of actuarial services in the same fashion, perhaps even to a greater degree.

The proposal before the Board makes it clear that independence requires both integrity and objectivity. In assessing the circumstances that impose obstacles to objectivity, however, the proposal pays attention only to relationships between the CPA firm and the client that can have such an effect. Where the involvement then is too close or too constant, or where there is a financial relationship, objectivity is said to be impaired. What the proposal fails to recognize is the classic principle that one cannot be objective about his or her own work. Even where a CPA firm has been scrupulous in giving advice, and only advice, and can ensure that all significant decisions are, as a practice matter, made by management, it is still the case that where the

advice is taken and acted upon, or even been given and rejected by the client, the independent evaluation that the public has the right to believe is an intrinsic part of an audit will be lacking. The persons involved in the audit will know in advance that a position on the determinations has been taken by one of their colleagues and will therefore not be capable of providing a truly independent check.

It has been argued by some accountants that an auditor, who has the necessary integrity and competence, will in practice make a wholly satisfactory evaluation of work done initially by an employee or colleague. It is also asserted that there is no "evidence" whatever to the contrary. This misses the point entirely. The identical argument could be made to support permitting auditors to have a moderate direct financial interest in a client. Of course, integrity and competence are extremely important. Experience has taught us, however, that objectivity and disinterest are also essential qualities in a person who reviews and evaluates the work of others. And, the proposal is unequivocal in stating that both independence and the appearance of independence are essential to public acceptance of the auditor's work. The effort to justify and reconcile self-review and objectivity appears to be contrived and should be rejected.

I would like to comment also on the statements that are being made that the accounting firms do not really audit the work of specialists. In the narrow sense, in the very narrow sense of the word, "audit" that in terms of accounting for the number of securities in the safe deposit box and that kind of thing, that may be true. They

do not generally get deeply involved in "number checking" as it relates to actuarial work.

However, in any reasonably broad sense of the word, "audit," they certainly do get involved in it.

As a pension actuary I have filled out 17 page questionnaires regarding actuarial assumptions and the source of the assumptions for auditing firms.

We know of cases where auditing firms have come in an independently done separate valuations of a pension plan, even without the knowledge of the client until after the fact. They have challenged assumptions. They have come in and done what amounts to a very thorough audit in some cases.

In the case of insurance company work, the firm I work has a group or division that handles the insurance company side of our business. One major part of that business is assisting CPA firms who do not have their own staff actuaries in reviewing the actuarial reserves of life companies. So I think it is very misleading to say that they do not "audit" the work of the specialist. It is a different kind of review, but the fact is there is a review. There has to be a review because the auditor is responsible for signing off on the bottom line. He is giving his opinion on the financial statement of the company, and he necessarily has to take that responsibility.

The question of whether actuarial services should be barred for other reasons requires consideration of separate issues posed by the Proposal--specifically, the issues of management decisions being made by the audit firm and related skills. The key to a determination as to whether the audit firm is involved in management functions is of course, a practice question of the extent to which its recommendations, by and large, over time, are sought or put into

effect. Also pertinent to this determination is the interpretation of "continuous involvement." For example, in the typical pension plan there is an annual valuation. If the actuary employed by the CPA firm carries out that annual valuation once a year--that is, if he is responsible for all the actuarial valuations--it seems to us that that is a continuous involvement even though it may be done on a more sporadic basis.

It has been pointed out previously, and I want to emphasize, in terms of this management decision question, that in the pension field, for example, the Enrolled Actuary must give his opinion that the actuarial assumptions represent his best estimate of the long-range experience of the plan. It is the Enrolled Actuary of the plan who must approve and provide an opinion on the assumptions. Management has the prerogative of firing that actuary if he does not agree with him and then must explain to the Labor Department why he did so. One might debate whether the actuary or management has the final control over actuarial assumptions, but it is clear that the actuary making the determination of minimum funding requirements under ERISA is deeply involved in the management decision process. He has a legal obligation to do so under ERISA. In addition, if the actuary employed by the CPA firm makes original determinations, which are then subject to review in a firm audited in response to a SEC firm, we again have a clear case of self-review.

With respect to the question of related skills, we think that consideration of the training requirements involved in qualifying to practice as a member of the actuarial profession demonstrates the significant difference in the

skills used by actuaries and those by CPAs. Actuarial examinations in the necessary disciplines typically cover some 40 hours of testing, which is almost twice as much as for a CPA, covering 9 examinations over a multi-year period, all of which, save for some elementary material, is material foreign to CPA exams.

The "bottom line" of the proposal comes down to the application of certain principles enumerated in the Proposal to six specific proposed services, and we will focus only on the two which affect the actuarial profession.

In analyzing the Proposal's Scope of Services criteria related to actuarial skills we have applied the three tests. One is the self-review concept; secondly, the management decision-making concept; and third, related skills.

We strongly endorse the prohibition on self-review by auditors. We agree with the AICPA admonitions against an auditor's involvement in management decision-making. As far as the related skills test is concerned, we take no position as to whether or not this is a legitimate test of the scope of services, but we will point out the implications of applying this test to the provision for actuarial services by CPA firms.

Our general conclusion, after reviewing the list of actuarial services which the AICPA has concluded as permissible for a CPA firm to offer, is that most of the permitted services are in direct conflict with the principles stated by the Proposal that should guide the decision on services which may be offered. We have analyzed the specific proposals made, and I won't repeat that analysis here. These comments deal with the details of why we think many of the provisions for services are

inconsistent with the underlying principles.

It appears to us that the list of permissible actuarial services is for the most part a list of current practices of CPA firms providing actuarial services and is inconsistent with the basic principles and state limitations on such services which are set forth in the Proposal.

If the AICPA position regarding related skills should be changed, I would modify our comments to a significant degree because many of the services that are under consideration would have to be rejected by the related skills test.

We appreciate the opportunity to be heard, and we will try to answer any questions you may have.

MR. GARRETT: Questions.

MR. McCLOY: I will put the same question I did to your predecessor about the tax service. There the element of self-review is present but nobody really seriously, I gather at this point, is suggesting that the accountant should not be able to render the tax service that they are now rendering or have been rendering for the last ten or twenty years or more. So that I raise the question again whether self-review is per se an impediment or an obstacle here to objectivity or independence.

MR. BOYNTON: I guess I really can't speak for the Academy as far as whether or not CPA firms should provide tax services. It is not our ballgame, but certainly the same principles, we feel, would control, which means that if the CPA firm was deeply involved in the preparation and determination of taxes and then turned around and audited them, I think they would still be subject to the same criticism.

MR. McCLOY: You want to proscribe it?

MR. BOYNTON: Right. I think the fundamental thing is that self-review is hard to

reconcile with the concept of independence. How can anyone review their own work and call it independence? It just boggles the mind as to how you can reach that conclusion.

There may be instances of minor things that are not important enough to make an issue of, but we feel that with respect to any material facts in the statement you cannot claim to be independent when you are reviewing your own work.

MR. WOOD: I asked a question on this very point. Would not a CPA firm be much better qualified to review the actuary's work, assuming you did it for the client, if it has on its staff experts in actuarial practice?

MR. BOYNTON: Yes. Let me make it clear; we are not saying that accounting firms should not employ actuaries and use them in the audit function or use them in other areas.

I believe where we would draw the line is when the actuary is involved with the preparation of material being subject to the auditor's opinion, and the same actuary--or the same firm is involved, both in the original determination and in the audit. Then we think there is a violation of independence requirements, but we have no quarrel with the concept, that an accounting firm that, say, audits life companies regularly would be well advised to have actuarial competence either on their own staff, or calling in other consulting actuaries to review their reserves. They must, "sign off" on the entire statement.

MR. LARRY J. LATTO: Just to amplify that slightly, there are actuarial services which can be rendered by an accounting firm to an audit client, but where the nature of those services are such that the results do not find their way to the balance

sheet, there is no reason at all, dealing only with the self-review concept, why there could be any objection to that, and there is no objection to it on the part of the Academy when dealing with the question of self-review because those determinations do not find themselves subject to review.

So it is useful to have that actuarial capability. No objection is made to that.

MR. BOYNTON: I think there was a question asked earlier by Mr. Manzoni, I believe, and I would like to respond to it. I think he posed a hypothetical question as if there was total reliance upon the actuary, and the accountant did not question the work of the actuary. If we assume he was allowed by SAS-11 or by AICPA Guides to rely upon the work of the qualified actuary, we have no quarrel with the concept of the accounting firm providing the basic actuarial services. There is no review involved. It is an acceptance of the work of a qualified actuary.

MR. MANZONI: As a user of financial statements, do you think auditors should audit actuarial determinations, or should they be permitted to rely on actuaries in that particular area?

MR. BOYNTON: As a professional actuary, and I am speaking for myself now, since I don't know that the Academy has taken a position, I would like to see reliance on the professional, yes.

MR. McCLOY: You would like to see?

MR. BOYNTON: Reliance.

MR. McCLOY: Didn't Mr. Keating say that the accountants generally did rely upon the actuarial opinion in the case where there was an outside actuarial judgment? That his experience was that the accountants did rely. There wasn't an element of review in that situation.

MR. BOYNTON: The practice varies rather widely. In any event, there is a review. The degree

of the review, the extent of the review varies widely. Some firms will go through a pro forma kind of questionnaire. They send you a short letter. Others go into a great deal of depth. We have other cases we know of where there has been great analysis of the actuarial assumptions by the reviewing firm.

I think in Mr. Keating's case and as in my own case, we both work for rather large, prominent, nationally known firms. We are a lot less likely to be challenged than will the small, independent actuary.

MR. McCLOY: But your point is that in every case there is an element of review.

MR. BOYNTON: There is an element of review. The degree varies.

MR. McCLOY: It is only as to competence.

MR. BOYNTON: Well, in some cases it goes well beyond just the competence area.

MR. McCLOY: But that is an element of review, to review the competence, I suppose.

With this educational business, what difference does it make how many hours the accountants are subject to examination in distinction to the qualification for the actuaries? If the people that are employed by the accountants are actuaries, they have to pass that examination.

MR. BOYNTON: If they are actuaries, yes, but we were saying the basic--

MR. McCLOY: I understand the position is that they do have qualified actuaries.

MR. BOYNTON: The point is that the educational program for actuaries and accountants is quite different. Someone trained as a CPA is not--

MR. McCLOY: I understand that.

MR. GUSTAFSON: I would like to make a comment on your question that you have asked several

times, Mr. McCloy, on the Federal income tax and tax services provided by accounting firms, and this is a thought that has just occurred to me here at this hearing. Is it significant in the probing questions that you have been asking that Federal income tax, uniquely Federal income tax, is subject to an additional audit through the IRS review itself?

MR. McCLOY: That isn't an identical situation.

MR. GUSTAFSON: That is not directly comparable to some of the others.

PROFESSOR CARY: The IRS audit would be years later when the statements will be out.

MR. GUSTAFSON: But it is inexorable.
(Laughter)

MR. GARRETT: But it also involves how much you reserve against how much you are going to lose.
(Laughter) It is auditing judgment.

MR. WOOD: I have another question too, Ray.
Do you have any objection in the Academy to a CPA firm providing actuarial services to a non-audit client?

MR. GUSTAFSON: None.

MR. BOYNTON: No.

MR. WOOD: No professional pride here.

MR. BOYNTON: We try to be consistent.

MR. GARRETT: You don't like it, but you have no objection to it. (Laughter)

MR. GUSTAFSON: I wouldn't even say I did not like it. I have no objection to it whatsoever.

MR. GARRETT: Those were my words.

MR. WOOD: So then, in effect, your whole argument here deals with an issue of the auditing profession and the Congressional interest in it. You are saying, in effect, that if it is a non-audit client, then Peat, Marwick can come in and do a fine

actuarial job, but if it happens to be an audit client, oh, no. So aren't you really here giving an opinion on an auditing issue?

You are talking about self-review. You know, that is your number one problem. Continuity of service.

MR. BOYNTON: The actuarial profession itself has looked at the independence question and has its own guidelines which do not allow for self-review. That is one reason we are here, because the interface where this comes up most frequently is with the accounting profession. That it actuaries working for accounting firms.

MR. GARRETT: Tell me more about the actuarial profession. They are not licensed, or are they? Do you have to be qualified in some official way, for example, to be an Enrolled Actuary under ERISA?

MR. BOYNTON: Under ERISA, yes, you enroll before a Joint Board, which is a government board.

MR. GARRETT: This is new then, isn't it?

MR. BOYNTON: Since 1974. It is the first statutory recognition in the pension field.

When you get to the insurance company side, which is controlled by states, the NAIC standard blank now requires--maybe Mr. Gustafson should answer that.

MR. GUSTAFSON: I will just stop you if you are wrong.

MR. BOYNTON: --that the statutory blank have an opinion by a qualified actuary, and that generally is defined by most states as a Member of the American Academy of Actuaries or some other person deemed qualified by the Commission of the state. So the two principal legal recognitions are in the NAIC requirements for the statutory blank

and ERISA for pensions.

MR. GARRETT: Does the Academy administer an examination?

MR. BOYNTON: The Academy itself does not administer an examination. One of the affiliated organizations does. The primary educational and testing body is the Society of Actuaries. The Society is a much older organization and it has long been giving examinations. They are the educational, research, testing organization.

MR. GARRETT: That is not governmental.

MR. McCLOY: No state or government, Federal government examination?

MR. BOYNTON: There is now a Federal government examination to become an enrolled actuary.

MR. McCLOY: That is the 40-hour thing that you are talking about?

MR. BOYNTON: No. The Joint Board exam is a one-day affair just on pension mathematics basically. The Society of Actuaries examinations cover a whole field of life insurance, accident and health, pensions. In addition, there is another organization, also within the umbrella of the Academy, called the Casualty Actuarial Society, which gives comparable examinations in the casualty insurance field.

MR. GARRETT: Does the degree of self-review vary significantly between, say, insurance and pension plan services?

MR. BOYNTON: Probably more heavily in the insurance company area.

MR. GARRETT: Of course, an insurance company would have to have an in-house actuary, or would it?

MR. BOYNTON: No.

MR. GARRETT: Does not have to have. The NAIC requirement does not require that the actuary be

an employee of the insurance company?

MR. BOYNTON: No. Many of the consulting firms have very large departments or divisions that consult with small life companies. I don't know what the count is, but there are 1,800 life companies.

MR. GUSTAFSON: About 300 of them have their own in-house actuarial staffs.

MR. GARRETT: The others use outside firms?

MR. GUSTAFSON: Yes.

MR. GARRETT: Do some of them use accounting firms for that purpose?

MR. BOYNTON: Yes.

MR. MATUSIAK: Did you say that the Academy has an independence standard for consultants?

MR. BOYNTON: We are in the process of developing additions to our Guides for Professional Conduct. The profession had a study by a committee which extended over a couple year period. Mr. Gustafson was a member of that committee. It came back with recommendations regarding independence of the actuary. The principles were adopted by the boards of the various organizations, and now they are in the process of being implemented by the organizations.

MR. MATUSIAK: Would it follow then that any member of the Academy would have to prohibit himself from doing what Mr. Keating said that he often had to do, namely, make management decisions?

MR. BOYNTON: No, the independence requirements do not get into the management decisions category.

MR. MATUSIAK: How is independence then defined or could be defined?

MR. LATTO: The circumstances under which independence would be required will be different.

There is no requirement, as there is not now, that a financial statement be certified by an independent actuary. There is no suggestion that there will be a requirement that an actuary must be independent of, say, the company for which he is working or a consulting actuary must be independent of a company for which he is doing work.

There will not be a comparable requirement as part of the independence rules of the Academy.

MR. MATUSIAK: But it will be permitted to make management decisions as Mr. Keating said he has to do.

MR. LATTO: There is no suggestion that there will be any change in what is going on now in that an actuary frequently finds himself involved in management decisions. Under those circumstances, independence will not be required.

MR. GUSTAFSON: May I comment on that, too. The distinction that was made by this study group based the distinction on the difference between an initial actuarial determination and an actuarial review.

We opined that independence is not required for a determination; that is, a management decision--the state of actuarial opinion that I append to my company's financial statement. But in the review function where an actuary is asked to review another actuary's work and that is done on occasions on life insurance company statements, most especially in purchase and merger situations, then we identify that independence must be present in the review function, so there was the distinction that we made.

MR. WOOD: Can Arthur Stedry Hansen's partners own stock in the company through which they are performing actuarial service?

MR. GUSTAFSON: Unless they are involved

in review. I guess I don't know. You answer that one.

MR. BOYNTON: There is no prohibition against it.

MR. LATTO: They may.

MR. WOOD: So if they decided to compromise their standards and reduce the funding requirements for their pension plan by 15 or 20 million dollars.

MR. LATTO: If they are not in the reviewing situation, they may be part of management. They may be employed--having a financial interest is no different than being employed. There is no independence requirement in that case. It is only when there is a review.

MR. WOOD: The CPAs don't let you own stock in the company.

MR. BOYNTON: The CPAs are in an audit situation.

There is a distinction. Most of my work is directly with clients making original determinations. We are not generally doing audit work.

MR. WOOD. It seems to me the original determination is more serious than the review.

MR. GUSTAFSON: There is no requirement that an accountant that is employed by a company be independent of the company, and he makes the original determination.

PROFESSOR CARY: I have a question that is total naive, but we run into numerous examples of so-called busted audits, frauds and that sort of thing.

Are there any examples of gross mistakes in actuarial determinations which have led to litigation and the like?

MR. BOYNTON: The case that pops in mind immediately is the name just whispered to me, which is Equity Funding. It was not really a gross actuarial mistake. It was just deceit.

MR. GUSTAFSON: The mistake was not an accident. (Laughter)

PROFESSOR CARY: I didn't think of that.

MR. BOYNTON: Nothing comes to mind, any prominent case at all of that kind of situation.

MR. MANZONI: Did Congress require enrolled actuaries to get involved in pension plans. Are you aware of any legislative history that suggests there needed to be some regulation there?

MR. BOYNTON: We endorsed the idea of having competent actuaries work with pension plans.

Mr. Manzoni: I don't know. Were there any cases brought before?

MR. BOYNTON: No. In fact, when we were discussing it with staff people, that was one response: Everything has been running fine so far. Why? One of the problems is that pension liabilities, long-term cost, do not emerge for many, many years, and the growth in pensions has really taken off in the last now 30 years. But it takes so long for a pension plan to mature and the growth has been so phenomenal the last several years that mistakes--I will be retired before my mistakes catch up with me, I hope.

MR. McCLOY: There were some pretty bad actuarial mistakes in connection with that Social Security legislation. (Laughter)

MR. BOYNTON: I prefer not to comment on that as President of the Academy.

MR. GARRETT: I think we had better move on. Thank you very much, gentlemen. We appreciate your coming.

Now Mr. Watson and Mr. Daskais. Conference of Actuaries in Public Practice.

MR. CHARLES B. H. WATSON: Good afternoon, gentlemen. My name is Charles Barry Watson, and I am President of the Conference of Actuaries in Public Practice.

Seated on my right is Richard Daskais. Both Mr. Daskais and I are members of independent firms of consulting actuaries and have substantial consulting experience.

The Conference did submit to you a written statement and, as a matter of fact, I handed to Mr. Matusiak this afternoon another version of it. I can assure you that this new version essentially corrects typographical errors and amplifies a few points. It is not intended to change the tenor of the statement.

Mr. Daskais was Chairman of the Conference Committee which drafted that statement, and he is here today in that capacity.

Since you have received our statement, I do not intend to read it or even to summarize it in depth. I would, however, like to comment on some of the points which are brought out in the statement.

I might say first of all, just to establish the background, that the Conference of Actuaries in Public Practice is one of the actuarial organizations in the United States which was referred to in the previous statement as being affiliated with the American Academy of Actuaries and which joined in its founding.

We presently have somewhat over 600 members. Nearly all those members are also members of the American Academy of Actuaries, but we are a specialist organization. Our members are actuaries engaged in public practice, and that means in most cases engaged in the practice of giving consulting advice on pension and employee benefit plans and to life insurance companies. Therefore, we have a very direct interest

in the matters which are before you this afternoon. This is why we have asked for the opportunity to make a statement.

I might add that the statements of our two organizations--the Conference and the Academy--were developed quite independently. For my own part, though, having just seen the Academy statement today, I find nothing inconsistent in that statement from what the Conference has said.

Unfortunately, though, there is a certain degree of repetition in the two statements. I apologize for this, but that is what happens when separate statements are developed by groups with similar concerns.

The major question which concerns us, as it has concerned the two previous testifiers, is the matter of self-review, or, if you wish, the matter of independence.

We have been basically told, and we have seen in the regulations and in the various pronouncements of the AICPA and others, that much of this concern about the possibility of self-review arising when the auditor makes use of a specialist who works for the auditing firm is removed or alleviated if the client is able to appreciate the significance of the advice given by that specialist, if he is able to have an informed judgment on what the specialist has done and therefore, in essence, embraces that work as his own.

So, therefore, the client makes the decision and it is his decision, and this presumably eliminates the question of whether there can be self-review, because it is the client's decision that is being audited.

It may be true that, for the purpose of reaching a decision in the most elementary sense,

it is sufficient that the client appreciates the significance of the advice he has been given and the likely results of taking that advice. He may look at the advice and say: "I like the results; I like what they do to my profit and loss statement," and accept it, or he may say, "I do not like the results, and I don't like what they do to my profit and loss statement," and reject it.

It may be that this is the type of elementary decision we are talking about, but unfortunately, such a decision process says nothing about the quality of the advice that has been given.

It is entirely possible for incompetent advice to provide "good" results, and for competent advice to provide "bad" results. Sometimes the competent adviser must be the bearer of bad news.

This is recognized, of course. The auditor realizes that it is not merely sufficient that the advice be accepted. The auditor is expected to render a judgment as to the quality of the advice which has been given. This is where we get into the requirement of SAS 11 that the auditor must in effect review the professional qualifications of the specialist and the way in which the specialist has conducted his work. It is assumed that this review of the qualifications and of the scope of work can be done in such a fashion that the auditor can satisfy himself as to the competence of the specialist.

The problem is that, as has been said in your Notice, this review must be done objectively if independence is to be preserved.

We argue that it is impossible for an individual to render an objective appraisal of the competence of someone who is a member of his own firm. I would certainly find it impossible

to be completely objective as to the competence of the work of another member of my firm, merely because I know him too well. I have built-in biases because of the fact of his relationship with me, and I must admit them.

In our statement, we did include perhaps the novelty of a dissent to the statement. One of the members of our Committee which drafted the statement is the employee of a CPA firm, and he appended a dissent which represented essentially his views. We are happy to present them.

In this dissent, he commented on the matter of self-review and independence and claimed that it would be possible to establish certain objective criteria--educational qualifications, years of practice, etc.--as to whether the auditor would accept the qualifications of a specialist.

It seems to us that such standards could be extremely broad, and in fact so broad as to perhaps go to the length that Mr. Manzoni raised in one of this questions, i.e., accepting the individual just on the basis that he is an Enrolled Actuary. If the standards were to be this broad, I wonder whether this would really be in the best interests of the public. It seems to me that the public should have a certain degree of concern as to the qualifications of the specialist. It is in this case, when the standards become more detailed, that I would argue that the issue of objectivity comes in, and whether an auditor can properly and objectively appraise the qualifications of his own colleagues.

A second major issue which is raised by your Notice is whether the actuarial adviser is involved in the decision-making process of management. Does the fact that one gives actuarial advice involve

him somehow in management?

The Conference would argue that an actuarial consultant has a certain degree of participation in the management process.

The client presents a problem to his actuarial consultant, and the consultant is asked to advise the client on how to solve that problem. The consultant offers alternative solutions to the client and tries to advise him as to the consequences of those solutions.

But then how broad is the range and scope of alternatives offered? If the scope is extremely broad--if, for example, the consultant is telling the client "Here is a buffet of facts and comments, go and take what you want from this plate, and what you want from that plate, and make your own decision"--one could argue there really is no need for the actuary. He merely dug out facts and laid them before his client. He is not really advising the client, and not making recommendations--which is the job he has been hired for, as a consultant.

On the other hand, the scope of the alternatives offered may be extremely narrow. One alternative. Do this, or don't do this.

In reality, the range lies somewhere in between. Usually it is not a case of yes or no, and not a case of take your pick. It is a question of: Here are several possibilities, and here are the potential consequences of each possibility, as the actuary sees them.

The client in this case does have the decision, but the point is that the actuary has so narrowed the scope of the alternatives available to the client--has so restricted the universe of possibilities from which the client can select--that he has in a very real sense participated in the decision-making process.

This is the general situation. There are also within the actuarial field two specific areas wherein statutory law effectively requires that the actuary participate in management decisions.

One of them is ERISA, and we have heard a great deal about that already today. ERISA mandates that the actuary, acting on behalf of the plan participants, is the individual who must choose the actuarial assumptions.

There are more things to be determined about a pension plan beyond the actuarial assumptions but I would argue, and I think that nearly everyone in my profession would agree with me, that it is the choice of the actuarial assumptions which ultimately determines whether a pension plan will be soundly funded.

Granted, there are different cost methods that can be chosen. There are different periods for amortizing the past service liabilities. Provided, however, these choices are made from within the legally permitted range of possibilities, then one will end up with a satisfactory result provided, and provided only, the actuarial assumptions are properly chosen.

In the life insurance company area, there is a legal constraint placed on the actuary who signs the annual statement. He is required to testify on his own reputation that the reserves make good and sufficient provision for the liabilities of the company. To my mind, anyone who can so testify must indeed participate in the management process.

I might add this participation goes so far that Best's Life-Health Insurance Reports often lists the consulting actuary as one of the officers of the company. I have before me a page from Best's on which Coopers & Lybrand is listed as an officer

of a particular life insurance company because they are the consulting actuary. Whatever this may mean in fact, it at least gives the appearance that Coopers & Lybrand participates in the management process of that insurance company.

MR. MATUSIAK: Are they also the auditors?

MR. WATSON: It does not say, and I agree that is a valid question. In any event, they are listed as an officer of the company.

On another matter, your Notice raises the question of continuity of employment. It is stated that, if one is continuously employed by a client, then there is a danger that he will at least appear to be involved in the management process, and such an appearance can compromise independence.

Your Notice make a distinction between periodicity and continuity which I find extremely subtle.

It is part of the nature of the services of an actuarial consultant that those services are rendered periodically, and not continuously. I would argue, though, that if every time a client thinks of an actuary, the words that immediately spring into his mind are Peat, Marwick, Mitchell, then this means that Peat Marwick is really acting continuously as the actuary. It is the only firm that is doing actuarial consulting work for the client. It is continuously hired but only periodically used.

Next, I come to the matter of scope of services. This is, I think, a very, very difficult question for us to deal with. Certainly it is not for actuaries to comment upon how the accounting profession wishes to limit the services that its firms provide. However, within the particular parameters that are laid down by the Notice--the

observations that the services should be accounting-related or auditing-related--I do think that we as actuaries have legitimate criticisms to express of the conclusions that are drawn from those parameters.

Quite frankly, we view actuaries and accountants as being very different. This morning, I heard myself described as a co-professional with accountants, and although I do not take real umbrage over this, I must confess it is the first time I had ever thought of it.

From the actuary's perspective, we view the accountants as basically looking backwards, while occasionally turning their heads to peer briefly into the future. We see actuaries as gazing constantly into the future, while once in a while looking backwards to check where we have come from.

I think Mr. Auerbach expressed this difference extremely well in this morning's session. He said that accountants are concerned with the current financial implications of past events, whereas actuaries are concerned with the current financial implications of future events. I would agree with this distinction.

To my mind, it is a distinction of type, not just of degree, and I think it does make actuaries and accountants radically different creatures.

I have had some personal experience with this difference when I was part of a committee of actuaries working with the AICPA to develop generally accepted accounting principles for life insurance companies. It became clear from the beginning that our two professions looked at the whole financial process in different ways. Put very simply, the accountant believed that, when you went from one year to the next, you were looking

at two income statements, and the balance sheet was merely the item which tied them together. The actuary, on the other hand, thought always of two balance sheets, and the income statement was the item which tied them together. To my mind, this is further evidence that basically we are different professions.

I can understand a desire to allow a scope of services which is very general, to say that any activity which involves the collection and analysis of data is somehow accounting-related, and to say that any activity which draws conclusions from data and makes evaluations based on it, is somehow auditing-related. This is, at least, how I read the parameters as they are defined within the Notice. In our opinion such a definition is far too broad, and in our statement we make a number of specific comments upon the ways in which we believe that the extent of services which the Notice suggests should be permitted is far broader than it should be, given the parameters of the Notice itself.

Finally, we would maintain that the public has expressed no clear need for actuarial services to be provided by CPA firms. Although we agree that the public is well served by competition, this competition already exists outside the CPA firms.

We heard this morning that it is the public's expanding expectations of auditors' responsibilities which leads to the desire on their part to provide these sorts of services. We do not see the great pressure from the public for this. There are clearly other ways of having these services provided.

We believe that it is important for the accounting profession and for this Board to make a judgment as to whether these sorts of services should be provided by CPA firms on the basis of

whether it is in the best interests of the CPA firms and of the public. Are these services truly supportive of the attest function, or are they diversionary?

Thank you very much, gentlemen, for the opportunity to make this statement. I would be very happy to answer questions.

MR. GARRETT: Thank you, Mr. Watson.

Do any of the Board members have questions?

MR. McCLOY: That was very interesting.

MR. MATUSIAK: If three consulting actuaries from the Conference were selected by a given client to perform the consulting services and all given the same facts by the client, how different would the results of the three actuaries be. Would they be similar, primarily similar or would they be diverse?

MR. DASKAIS: Let's talk about it as to different situations. One is a pension situation under ERISA where each one has to come up with his best estimate, and then in the insurance company situation, there is perhaps more latitude.

Both of us are pension actuaries, by the way.

I would think that there would be significant difference, but on the order of 10, 20, 30% would not be unexpected as to the required contributions under ERISA of three highly competent actuaries.

MR. MATUSIAK: Does that speak for the need for having a review by a consultant or another consultant's work?

MR. DASKAIS: These differences would primarily arise out of different expectations about macro economics, basically interest rates and salary increases which ERISA has made all of us experts on, but we may not be quite as expert as the

economists who I understand disagree from time to time. (Laughter)

MR. STARK: While you were speaking, I was looking at the appendix page 22 and 23 which set forth the Executive Committee's proposal regarding employee benefit consulting services. I understand that is the area in which both of your gentlemen are experts.

I notice that the Executive Committee's proposal deals with many of the points that you made. For example, you have made the point that the accounting firm should not get into making management decisions, and that is the very first point that the Executive Committee makes. You mentioned that the auditing firms should not get into the position of continuous involvement, and that is the second point that the Executive Committee mentions. You also mentioned the necessity of assuring that the client has sufficient comprehension to be able to make a management decision, and that is the third point that is made.

I am not sure I understand exactly where you would fault the Executive Committee's proposal.

MR. WATSON: I would certainly not fault, in any sense, the proposals that the Executive Committee has made as to the criteria which should determine whether these services be provided or not. Our problem is that we do not agree with the conclusions that are drawn from the criteria.

Basically, we view, certainly in the case of ERISA where one acts as an Enrolled Actuary, and I would argue in many other areas, one inevitably becomes in some fashion entangled in the management decision.

We would also argue that, even though the provision of actuarial services might appear to be periodic in that the actuary only comes in once a year to value the pension plan, that is effectively

a continuing assignment which is done year after year, and therefore is indeed a continuous assignment.

Thirdly, there is the question of whether the client has the understanding to make the actuary's work "his own" for decision-making purposes. This is certainly arguable. As I tried to make clear at the beginning of my presentation, there is a distinction between the client understanding the results and the consequences that flow from them and the client adequately appreciating what has gone into producing those results. That is where I believe the audit function does become important.

By the way, you may have noticed from our statement that we also support the principle that an auditing firm should have available to it, either on its own staff or through the services of an outside consulting firm, actuarial expertise in order to reassure the auditor, if he needs reassurance, that the actuarial work has been carried out properly. We do not disagree with the parameters, the criteria of the Notice.

MR. STARK: It is impractical to carry them out.

MR. WATSON: We just disagree with the consequences.

PROFESSOR CARY: It is practically impossible on your part to carry them out on your part. Isn't that right? That is what you are saying.

MR. WATSON: Yes.

MR. STARK: I was interested also in your memorandum which says that you would oppose auditing firms providing actuarial services to non-audit clients.

It seems to me that is a difficult line to draw when your major premise is the difficulty in relation to the audit clients.

I can't see that you can extend that logically to the non-audit client.

MR. DASKAIS: I think there we were applying the criteria suggested in the Notice for Hearing of: Are the skills audit related?

We do not consider actuarial skills audit related, and therefore, accepting that criterion, we would say if that criterion is to apply to non-audit clients, then it would not be appropriate for auditing firms to provide actuarial services for non-audit clients.

MR. MANZONI: Would it be wise to have an actuary on the staff of an accounting firm?

MR. WATSON: Oh, yes.

MR. MANZONI: Is that consistent with actuarial skills not being audit related?

MR. WATSON: First of all, I would certainly maintain that it would be desirable for an auditing firm, as was said a minute ago, to have an actuary available to assist in all the actuarial aspects of auditing and it would probably be very desirable to have this actuary on the staff of the firm itself for that purpose.

Secondly, I think that we have to make the same caveat that the Academy did in our objection to the provision of the actuarial service of non-audit clients. We were operating strictly within the framework here.

If the provisions with respect to auditing-related and accounting-related services were to be relaxed, then we would have a different position to maintain. We were doubtful as to the desirability of providing any actuarial services basically because of the restrictions there provisions led to.

MR. GARRETT: Thank you, gentlemen. I

really believe we had better cut this off now, or we will get even further behind in our timetable.

MR. WATSON: Thank you very much.

MR. GARRETT: Let's take a short standup break of about five minutes.

(A short recess was taken.)

MR. GARRETT: Let's resume, please. Mr. Cardinal, will you proceed, please.

MR. ROBERT J. CARDINAL: Thank you, Mr. Chairman. Mr. Chairman, I have submitted a statement. Knowing the load of reading which you have had, I would like to summarize it briefly.

First, I would like to thank you for this opportunity to appear before you and present my opinion and that of the company which I represent on what we feel is a very critical issue.

In the statement I reviewed my background and that of the company. Very briefly, I have degrees in engineering and management. I am on the staff of a graduate management school. I am a certified management consultant, Director of the Institute of Management Consultants, and have been in consulting for 12 or 13 years with Lester B. Knight & Associates, headquartered here in Chicago.

During that time I have headed up almost all of our various areas of practice including being the head of all of our management consulting. I am currently Executive Vice President.

In addition, during my career, I have run companies and been a buyer, both management consulting and audit services. I have been on both sides of the fence.

Our firm is a large one for our business, with about a thousand professionals providing management consulting and consulting engineering services. We have been in business for 33 years and completed some 18,000 assignments in 53 countries.

Of the several questions which have been discussed here, it would seem that the most paramount issue is the one which is stated on page 7 of the Notice of the meeting, and if I may quote it. It is "Whether management advisory

services furnished to an audit client either compromise the audit firm's independence or create the appearance of compromising its independence." And I would emphasize that last portion.

There are other questions that have been raised by many in my profession, and in my opinion, they are either moot or belong outside the realm of this Board and certainly of the government controls that have been discussed.

I happen to believe, and my firm believes, that CPA firms can hire people who are equally competent as any of ours and are as capable of doing quality work as are we or any other independent management consulting organization.

There is a great deal of concern among many in my profession regarding the apparently unfair advantage held by CPAs in acquiring work. I have to acknowledge that this certainly has an advantage in many situations, and I envy them.

I also envy those of my contemporaries who do executive recruiting and place a key executive or those who sit on the board of directors of a firm and then do work for them, or who happen to play golf with the key decision-maker and walk away with an assignment.

But I don't think there is anything we should do to prohibit these or any other form of advantages in a competitive environment. I think that if we have a better product or service than do the CPA firms, (we being the independent management consultants), then we should just get about our business of trying to sell this to the public and to management and informing them of what we have.

I don't think we should be looking for regulation to control advantages in business or crying on any government agency's shoulders.

A lot of the selections are based on faith and trust, and they are always going to be based on personal relationships.

The independence of the MAS practice and the influence of the audit practice on management consulting services is another source of some concern within my profession of management consulting.

However, I feel we have similar potentials for conflicts of interest all throughout management consulting. We all have to be constantly aware and police them. I think the Institute of Management Consultants has taken one step, and I think they have provided a statement to you. They require an attestation of independence on the part of the MAS practitioners in the CPA firms basically stating that the MAS practitioner reports to an independent MAS control and is not subject to undue influence, but I think this addresses only the independence in management consulting. That is a private service to a generally educated and aware clientele, i.e., the management of the firms and the associations. I don't think it addresses the central issue for this committee which I would like to get back to, and as I stated before, it is the influence the other way around of management advisory services on the public audit.

The certified public audit is created, as we all know, by law, regulation, and it is essentially a guaranteed market which is the exclusive practice of CPA firms. In fact, with the largest firms, it is almost the exclusive province of the big eight CPA firms.

They have a very specific trust. They act as middlemen or interpreters to represent the public which provides the capital for the operation of these firms. They are held in such a position of trust

that senior citizens when investing their savings rely on that signature and the letter in the annual report. That is a unique position of trust.

I think we owe this public a certification which is not only independent, but beyond any suggestion of any taint or loss of independence from any source whatsoever.

The public today, as we all know, has lost a great deal of its faith in government and business, and I think we should rebuild this faith by not compromising our principles for the sake of expediency or more revenue or a few more partners.

Many of the management consulting services proposed by the CPA firms to remain a part of the MAS practice, present opportunities for conflicts of interest and certainly cast some doubt or give reason to doubt the possible independence of the public audit by the same firm.

Let me just pause for a moment and say that the limitation of services that we announced in the appendix of the Notice of this hearing is, in our opinion, almost no limitation whatsoever. The criteria are a limitation, but the actual services from which they are limited is almost no limitation whatsoever, and it would appear to us that they would be continuing to perform essentially the full range of management consulting services.

Let me cite some examples of the kinds of services with which you are familiar that can raise doubts as to the independence of a public audit by the same firm.

One type is strategic planning and organization. It is a significant portion of management consulting practice of most firms, and involves working with top management as many of you have to devise long-range or strategic plans and develop the

organization necessary to carry these out.

It results in major changes in directions. It results in new product lines, organization revisions, acquisitions, divestitures, and major investments in new programs.

Many of these have been successful, but there are also many examples of unsuccessful strategies. Such as the number of companies that we are all aware of that have gone into and out of the computer business, and who have lost millions of dollars in this business.

How independent can a public auditor be when he is going through and auditing a company that has just gone through a major change of direction and strategy such as these but where that strategy was developed and recommended by the partners and principals of the same firm and where the audit partner shares the professional liability for the actions.

I am not trying to suggest that there is an intentional misleading of the public, but rather acknowledging recognized human frailties.

I know when I am auditing someone's else's work I am much more critical and point out shortcomings much more quickly, I think, than I do when I am auditing someone's work whom I have directed or which was performed by someone whom I personally know of with whom I have a relationship.

I think we tend to be blinded by our friendship, our relationship with that individual, our confidence in what he can do, and we lose sight of what the facts show us. Certainly there is cause for the public to have doubt in these situations.

Another area is financial and management systems. A major cause of poor performance of

many companies is poor costing, poor pricing, nonresponsiveness due to a lack of financial and management information. The design and installation of systems to correct this usually using computers is a major portion of the business of many of the MAS practices of CPA firms.

This can be one of the major expenditures facing any company, and what is more critical, the results are a long time in coming, and they are often very subjective. It is difficult to determine whether or not the investment is going to pay off, and the information is going to be valid.

It is no uncommon, as a matter of fact, for one of our client to suggest utilizing the services of a CPA firm to audit our progress and the results of our programs in this area.

I have got to confess it does keep us on our toes, and I think it is a proper role for the CPA firms when they are not trying to compete for the same business. When a CPA firm designs and installs this system, who audits and reports on the progress and the results? The same audit firm? Management literally is just replete with stories of misguided systems programs, as I am sure every one in the room knows.

We often come in to a client who has had an aborted effort sometimes involving years of time and millions of dollars. The question is how independent an auditor can be in reporting on a systems installation when it is his firm and his partners who are responsible for the project.

These are not simple questions in the systems areas because well designed systems often lie unused and fail because management doesn't

support them or sometimes because of the inability of the management team to use them, and a consultant rightly or wrongly usually tends to share in some of the blame.

We really question, and we think the public would question whether an auditor can be sufficiently diligent in reporting a shortcoming on a financial or management system when his partners have done the design and installation and he shares in their professional liability.

Another service which is remaining in the province of the MAS firms as we see the announcement is facilities planning. Somehow it has been determined that this relates to accounting. I must confess that as a practicing registered professional engineer and having done a lot of facility planning, I don't see that relationship. This involves a complex set of interrelationships between management plans, industrial engineering, product design, manufacturing processes, machining, inventory control, material storage, et cetera. These facilities often require major long-term capital commitment. They can require relocations of families. They oftentimes mean growth or death of a community.

Many of our clients require detailed appropriation requests. They are subject to extensive analysis and scrutiny by their internal and/or their public auditors.

The increased sales, the reduced cost, the improved productivity have to be projected to justify these capital expenditures and then these are usually audited after the fact to determine whether or not they were obtained or were false promises made.

Despite all the planning and analysis, corporations, agencies, the government, all build

white elephants. The facility planning projects do go wrong. Some one has to find them. We only have to look in the real estate section of any major city to find all the ones that went wrong.

Sales projections don't develop as planned. Labor problems develop. The public has adequate cause to question, in our mind, the diligence of a public auditor in reviewing the performance of a major new facility or a major capital investment when, in fact, his firm through the MAS partners received a handsome fee for doing the industrial engineering or the planning of the facility and possibly recommended that it be built.

Another example what we won't discuss in detail is acquisition and merger analysis. A practice that is often performed by management consulting organizations, this is not doing brokerage or finding merger and acquisition, but evaluating some or all aspects of a merger or acquisition.

These are difficult questions. They are based on a relative probability and business feasibility of some future action occurring. Everyone has to feel they are getting a value, so therefore, it isn't some simple recommendation or simple analysis. You really need an independent auditor to analyze whether the results of an acquisition or a merger is successful.

It requires an outside hard look at these things. We have serious reservations that with the significant dollars that are involved--I think IC just paid 400 million dollars to get Pet--with the significant size of some of these things, doesn't the investing public have a right to question the independence and the objectivity of an auditor who is reporting on a performance of a new

combination, when, in fact, it was his firm that made the recommendations and may even have helped establish the price.

Again, the critical question in today's environment of doubt is not if the auditor is independent, but whether or not we have given cause to the public to doubt his independence. That to us is the major question.

I won't go on with a long series of examples, but we think there are a lot more in the areas that the CPAs are proposing to remain in, and we ask that consideration be given that they not be allowed to perform MAS with their audit clients.

Mr. Chairman, if there are any questions for me, I will be glad to try to answer them.

MR. McCLOY: What is the net result? What is the bottom line of your advice? That they be directly excluded from all MAS?

MR. CARDINAL: No, just MAS with their audit clients. I am not one of those that believe they ought to be kept out of MAS. I think they can do a good job, but I don't think they should be doing it for their audit clients.

MR. McCLOY: In other words, without exception.

MR. CARDINAL: Yes, sir.

MR. WOOD: Professor Cary this morning, if you were here, asked whether CPAs should involve themselves in performance reviews.

It seems to me one of your principal points of departure here is that a CPA firm would be compromised because its MAS people had recommended the installation, let's say, of a particular plant or a strategic plan for the company, and the P & L came up that the profits weren't as planned.

Are you recommending that CPAs conduct

performance reviews? It seems to me what they are supposed to do is check the accounting system and the inventory controls and so forth, the quality of internal controls, and then certify the results in the P & L and the balance sheet.

MR. CARDINAL: You mean the performance reviews of the projects or the individuals?

MR. WOOD: Of the projects.

MR. CARDINAL: Of the projects? I think I have seen them successfully utilized for that when there are not any other conflicts. When management has said: We would like an outsider to take a look, and audit if, in fact, these results are coming as planned because they are difficult questions.

The numbers tend to get blended in. The sales are up, but would they have gone up, or is it the result of this program or not. I have seen CPAs used very effectively for that.

MR. WOOD: For them to do it, if you recommend that they should do it, then they should have expertise in house to do just this.

MR. CARDINAL: The expertise becomes a financial one. It is a matter of reviewing the results and the numbers.

MR. WOOD: All right, reviewing the results. The results are that this new plant has produced a loss, period.

MR. CARDINAL: Right.

MR. WOOD: That is enough for management to get busy and say, "What went wrong?"

MR. CARDINAL: Fine. That is what I am suggesting.

MR. WOOD: I don't see anything wrong with that.

MR. CARDINAL: That is all that I am

suggesting.

MR. McCLOY: You are only suggesting that management get alert again.

MR. CARDINAL: One could say that.

MR. McCLOY: De novo, when you start out, would you eliminate all these MASSs in the hands of accountants?

MR. CARDINAL: No, quite frankly, I think what would happen would make my own life much more difficult, but I believe strongly enough in the principle to persist. I suspect the answer, were such a rule to come down, is they would probably become an independent organization and relieved of some of the restrictions that some of them do have from their parents, and they would probably become twice the competitors that they are today.

MR. GARRETT: And they would spin off the MAS departments?

MR. CARDINAL: Yes, and then they would really be tough, but I believe enough in the principle of it that if that is the way it goes, so be it.

MR. GARRETT: I can understand if management decided they wanted an outside review in respect to a particular project and the regular auditors that participated in planning that project, that review wouldn't seem very outside, but for the ordinary attest function for ordinary financial statements, why would the auditor be contaminated in some way in reporting the results because he participated in the planning?

MR. CARDINAL: We are blinded by our faith in the people we know, and if the results of a new project are not going as planned, but we have at the assurances of some known individuals, we think this is going to come out all right. Because we planned it, we know it is going to come out all

right, we tend to be more lenient, and I think the critical question is beyond that. Again, "does it give the public cause to doubt the independent." If, in fact, someone has spent 150 million dollars for a facility, I think the public could have cause to doubt the audit on the results of that performance if it is done by the same organization who helped plan it.

MR. GARRETT: The audit of the results of the project is something different from the audit of the financial statements.

MR. CARDINAL: But the annual financial statement can be significantly influenced by the results of these major capital expenditures of facility plans, sir.

PROFESSOR CARY: Not in the year of the planning or not in the year of the activity.

MR. CARDINAL: No.

PROFESSOR CARY: It could be in years hence. Therefore, you are assuming that somehow they will be altering their audits over a period of years in order to demonstrate that the project that they planned, or whatever, or the facility or what-have-you, has been successful rather than unsuccessful.

MR. CARDINAL: I have been very careful not to suggest, sir, that they have modified any audits. What I am saying is that the situation arises which can give cause to the public which they are intended to be representing to, that there was a loss of independence and a conflict of interest, and, in fact, they have been the recommender and a party and share in the professional liability for errors in the planning of a project and development of a project, I think the public has a cause to doubt the independence of the audit.

MR. WOOD: May I ask a simple, silly

question.

MR. CARDINAL: If there is such a thing.

MR. WOOD: How does the public know that the audit firm performs an MAS for the client?

MR. CARDINAL: In some cases they do become aware of it. I really don't know the public source of knowledge.

MR. GARRETT: They will from now on with the new rules.

MR. WOOD: Do we have to specify in the annual report that the MAS was in a certain area?

MR. GARRETT: We don't know yet, Arthur. By type of service, but whether it would have to be more specific than than, I think we will have to find out.

MR. CARDINAL: The question, it would almost seem to me is: Does the fact that we are not going to tell the public unless they get in there and find out, make it any lesser of a conflict, I suppose. When people do find out, then it is almost like you are keeping it a secret, because the information is available if someone asks and looks. It becomes quite visible. It is hard to hide who you are when you are around these organizations.

MR. WOOD: There are a lot of philosophical arguments here. It has been brought out today that the accounting firms consider themselves to be just as honest and competent and their standards of integrity are as good as the consulting world or the actuarial world or any other, and the appearance of independence gets an awful lot of emphasis out there.

I think that I, for one, have a difficult time in finding incompatible the integrity of an accounting firm on its audit side with its service side. I don't like to see the government or the SEC, for example, unless there are real factual grounds

or bases for experience where there have been failures where an auditing firm might be found to have given poor advice and then covered it up, for us to inhibit services where hundreds of small companies, for example, can't afford to have separate consultants, they work with accounting firms to perform all kinds of services, and I am just troubled. I need some help, I think, on this question of appearances of independence.

MR. CARDINAL: I think the appearance is a very critical question in today's world, sir. As I said, I have been one of those within our profession who has stood up and felt that the MAS groups can perform as good a management consulting as any of us, that their conflicts of interest on the management consulting side versus audit is probably no more, no less, than many of our own. We have to police them.

I think when you get to the audit side, however, there is a specific public responsibility. You are not dealing with an aware, educated clientele such as the management. You are dealing with the public, and I think the public has lost enough confidence in public institutions these days that I don't think we should contribute to it, and appearance of conflict can be as important as conflict itself in decisions affecting the public because you don't often get a chance to prove your well meaning with the public.

MR. MATUSIAK: The Cohen Commission suggested that the more knowledge that the public has about the services performed by CPA firms, the less they are concerned about the impairment of independence. Therefore, the Cohen Commission suggested that perhaps what was needed is an educational program on the part of the profession to educate the public as to what CPA firms do. How would you respond to that?

MR. CARDINAL: I think any education that

that you can do in that area is fine, but I still feel that appearance of conflict becomes an equal problem whether they are educated or not. It might just make them more aware to what Mr. Wood was saying of finding out what other services they might have provided, and they might start asking who were the consultants that advised on this acquisition or this merger or who worked on such-and-such a firm.

MR. McCLOY: You might build up confidence as they examine that.

MR. CARDINAL: It might go either way.

MR. GARRETT: They will begin to get educated with the next proxy season. One might wait and see how that works out.

I can imagine that if the auditors had worked in planning on a project and the project was a turkey, that they might be a little late in recommending recognition of the loss, and a big writeoff and things of that kind. You certainly have got on the inside of firms in the course of your profession, I am sure. I wouldn't dream of asking you to name anybody. Have you actually seen this or thought you have seen it?

MR. CARDINAL: I won't say that I have seen any instances where auditors have tried to cover that up, no sir. I have seen a lot of projects go wrong. I have not seen instances of coverup.

MR. CARDINAL: Be slow or whatever.

MR. GARRETT: Someone might say, "We will have to write it off this year. It's a dud." And they say, "No, give it one more year. We will put in another little gimmick and see what happens."

MR. CARDINAL: I haven't gone looking for them either, frankly.

MR. GARRETT: Lou, is there coffee back there? We will take ten minutes.

(A short recess was taken.)

MR. GARRETT: Please resume your seats.

Robert Mautz and Thomas Testman.

MR. ROBERT K. MAUTZ: My name is Robert Mautz. I am a partner in the firm of Ernst & Ernst. I am accompanied by my partner, Thomas Testman, this afternoon. Tom is in charge of our management advisory services on a firm-wide basis.

We appreciate the opportunity to meet with you and to express our views. We have already supplied you with a paper, including a summary, and we will try to help you get back on schedule a little by not reading that paper or any part of the summary.

It may be useful, however, in view of some of what has been said here today, to express our views a little differently. I will try to be brief.

We think that the reasons offered for restricting the scope of CPA services, as they have been expressed so far, tend to fall into two groups. One is the question of independence; the other is the question of compatibility or image of status or credibility or whatever. We think the matter of independence is a very real issue, and an important one. It is really an unavoidable issue in view of the way the profession of public accounting is structured. But it is an issue not so much of scope of services as it is one of source of fee. As long as the independent CPA gets his fee from the audited client, his ultimate independence is bound to be questioned. Because of that relationship, and because CPAs recognize it and have been concerned about it for a long, long time, we practicing CPAs have developed a whole array of controls which are designed to protect and assure our audit independence. These include such things as the way we recruit, our staff training programs, our rules regarding financial interests, the divisions of duties we have within the firm, the procedures

we have for accepting engagements accepting clients, our second partner reviews, the partner rotation program that we will have now, intrafirm peer review, external peer review, and now, as some one pointed out this morning, perhaps the most important of all is audit committee review of our independence.

All of these are designed to assure, as well as we can, given the structure of the profession, that we are independent. Some of these provisions are quite burdensome and all of them are expensive. In addition to this, we have the ever present threat of litigation which gives us every reason to strive to meet these requirements and to be as independent as we can.

So we see independence, then, as something about which we have taken a great many positive steps, and we see restriction of services in any way at all as not really helping with the basic problem. If we restrict any one service, about all we are saying is that we are not really content with the extent of our independence efforts. We could restrict services a long, long way, but unless we restrict the audit service right out of existence, we don't get to the real basis of the independence issue. We see the restriction of scope of services with respect to independence. First as superfluous because we already have a satisfactory array of relevant controls, and second, as irrelevant to the basic question.

With respect to compatibility or image or status or credibility because we supply management advisory services, we tend to think of this as not important because market forces will take care of it. It is true that when we accountants are authorized to provide the attest function, we are given a very important and a very valuable authority,

but no guarantee of any clients comes with that authority.

The profession is guaranteed clients, but no individual firm is. Ours is a very competitive profession. Each firm must provide services that clients want badly enough to pay for them. We must have sufficient credibility and status, on the basis of whatever standards clients use, that we impress them with the fact that we can meet their needs which includes being accepted as independent.

Companies are free to choose their independent auditors. Differences among CPA firms, including differences in the scope of their services, provide an opportunity for choice on the part of companies. We think that companies in search of independent auditors will themselves discipline the profession if its members engage in activities which threaten their audit independence.

Mr. Cary has asked a number of people and he has indicated he will ask us all today the question of what would happen if an announcement appeared tomorrow in the paper that Booz, Allen & Hamilton and one of the major firms had merged. I can't speak for the clients of other firms, but if they were our clients, they would be on the phone immediately to ask what in heaven's name we were doing. They have arranged with us to be their auditors. Are we changing our emphasis? Are we changing the nature of our professional commitment? Do we want to become something we weren't before? That would be a sufficient change that many, many of our important clients would be very interested and would comment to us.

This is not to say, on the other hand, that we would not be interested in merging with some management advisory services firm somewhere

if it had a degree of competence in something that we were interested in and needed in that locality. We would probably seek such expertise, but that does not mean that we could ignore client reaction. We must always give thought to how our clients will react to any activity that would indicate a major change in direction.

Clients feel we have a commitment to them just as we feel they have a commitment to treat us honestly and fairly. So we see the market system taking pretty good care of this matter of compatibility of MAS with auditing. We view any artificial limitations of the scope of services as constituting an interference with the functioning of the market system, and we tend to think that there is too much interference with that system already.

May I add just two more thoughts before we take your questions. The first is that the total range of services which public accountants engage in isn't nearly as broad as is often implied. There is a general consensus that we restrict ourselves to a reasonable range that relates to our basic audit function. There are all kinds of things that we would not do.

You have asked some people the question: Are there any services you would not perform? There are a whole lot of these. We wouldn't do an appraisal for you. We wouldn't give you investment advice. We wouldn't plan an insurance program. We wouldn't conduct a fund raising program or an advertising campaign. We wouldn't do anything for you about public relations. We could run through a whole list of these. There are lots of things that we wouldn't dream of doing.

There is really a fairly narrow range for management advisory services, and there are only a

few services that some firms perform that most of the other firms do not.

The other point I would like to make was brought up by the preceding commentator. That is this matter of how the public perceives our independence and whether the public is really concerned about our appearance of independence.

The question is whom are we talking about as the public? If we mean the little old lady in tennis shoes, she doesn't have the faintest idea about things like this, and she is not interested. If we are concerned about the skilled and qualified financial analysts, they seem very unbothered by the whole thing. I don't see any of them here to make an oral statement or writing about this in their professional literature, or really concerned about it in any way at all. Whatever ways they have of determining whether or not we are satisfactorily independent, they apparently are satisfied. I tend to think that the people who raise the independence issue the loudest are academics who need something to write about. I can say this rather bluntly because I spent a quarter of a century as an academic, in some cases writing about the independence issue.
(Laughter)

PROFESSOR CARY: What position?

MR. MAUTZ: I was very critical, Mr. Cary., and I could be because I had no direct interest in it. Some of my friends come to me now and they say, "Bob, you have changed your position."

That is a very hard question to answer fairly. Yes, I have changed my position. But I have changed it over a period of some 15 or 16 years during which the profession has also changed. Many of the present controls to protect independence didn't exist that long ago. I have changed my position

because I know a whole lot more about the subject now than I did then. It is very easy to be critical of that which you know very little about. It is very easy to sit in the comfort of a classroom and talk to your students or write about those practitioners and what they should or shouldn't do without recognizing what the impact of that can be not only on the firm and its partner, but upon clients and their needs.

I didn't mean to go on this long. Tom and I will be glad to try to answer any questions that you have.

MR. McCLOY: Do you see any field at all, any area at all here, where we, the POB, could be helpful in restoring the credibility of the profession by way of any limitation of the MAS?

MR. MAUTZ: One of the services we shouldn't render is giving political advice and really this has become a political question. (Applause)

PROFESSOR CARY: That is very good.

MR. GARRETT: Why do you think we are lawyers up here?

MR. MAUTZ: I think it may be very, very important politically that some kind of a concession is made, but I think from a substantive point of view that concession won't mean a thing, and it will hold the wolves off only for a very short time. I recognize it is very easy for me sitting here to say that you should be courageous, take the right position, and wait to see what happens. If I were in your position, I don't quite know what I would do, but I can't see restriction of the scope of our services as any kind of a lasting solution.

MR. McCLOY: You would put no outside restrictions at all on MAS?

MR. MAUTZ: No, I would vote for the free market and let it go at that.

MR. McCLOY: Even at the risk of government regulation instead of self-regulation of the profession?

MR. MAUTZ: There is a very fine difference between government enforced self-regulation and honest to goodness self-regulation. I think in this case we may get regulation, but I would rather it were forced upon us than we volunteered it because I don't believe it is substantive or effective or useful in the long run.

PROFESSOR CARY: I have a couple of questions. One, I noticed that Ernst & Ernst doesn't engage in actuarial work. Is that a matter of principle or don't you think it is profitable, or what is the reason, because you do engage in quite a variety of MAS types of services?

MR. MAUTZ: I am not sure I can answer that question. Sometimes there is a pretty fine difference between principles and profits. We do have some actuaries on our staff. We have been acquiring them because we feel that we need them in our insurance audits. We are very heavy in the insurance field.

With such expertise available, I can see where we might be led to render some client an actuarial service. You move from one step to another. Once you have the service available, your clients know you have it available, and they may ask for it. I wouldn't want to pre-empt the decision that will be made some day as to how far we will go in offering actuarial services. It is a little hard to see the direction in which auditing will develop. We have seen over the last two decades an increase in the breadth of the auditing service we are called upon to do, including some kinds of things that at the moment we won't do. I am sure we don't do them now for a number of reasons. Whether we will offer that service in five or ten years from now will depend upon the trends in

the profession, what others do, how useful the service is, and whether clients demand it.

PROFESSOR CARY: That ties in with the question you referred to. You are right. I was going to ask about your merging with Booz, Allen or something like that. Your reply was: Well, that it is a political question, that what you would do, it would shock your clients because you do it too fast, but if you merged with one small actuarial firm and a very first class young management consulting firm and so forth, in principle this doesn't bother you. This is a proper proliferation of the roles that your firm can perform. Right?

MR. MAUTZ: If that consulting firm was providing a service and had a competence that we thought we needed to serve our client, I would see nothing wrong in principle with us doing it.

PROFESSOR CARY: Then how do you go to geologists and appraisers? Why not those?

MR. MAUTZ: I guess there are a couple of reasons I could mention. One is that we have the problem not only of providing the competence, but having in our partner category the ability to manage that competence and to supervise it.

We would be a long time developing that supervisory ability in geology. That is not to say we couldn't but we would be a long time developing it. And then we come back to the point: What are we in business for? We are in business to make a profit, but not solely to make a profit. We are proud of being accountants. We are an accounting and auditing firm. We want to be thought of as such. I think there are a number of things that we could do, services that our clients would accept but that we just feel are out of our range of interest as a professional firm. Whether that would be geology

or something else, I don't know, but there are bound to be limits. I think we have no intention of trying to be all things to all people.

PROFESSOR CARY: There is much difference between plant layout and geology in the sense that they are both unrelated to accounting, aren't they, would you say?

MR. MAUTZ: You can relate them if you try hard enough. Let me try a little bit. Not geology. I won't try that. You mentioned plant layout. We are very concerned about internal control. That is certainly accounting. We are also concerned about inventory control. Internal control over inventory has to do with warehouses and the physical transfers of product, locked storerooms, records, and the like. It might be that occasionally we would be asked by a client to give some advice on how to improve internal control over materials handling, and we would get into some form of plant layout in that way.

That doesn't mean that we set ourselves up as experts in general plant layout and that we would start from scratch in designing a complete plant layout for someone. We may be drawn into those things by our interest in internal control.

PROFESSOR CARY: I was just trying to see where you draw lines.

MR. MAUTZ: Some lines are very hard to draw, as you know. The ends are very clear, but in the middle it gets very fuzzy, and this is one of them.

MR. McCLOY: Do you do executive recruiting?

MR. MAUTZ: The firm does, yes, sir.

MR. WOOD: At the outset you pointed out independence and compatibility were the two principal facets of this problem, two principal considerations on MAS.

You used interchangeably, or you mentioned

compatibility or image. Doesn't image go to independence, this appearance question, rather than to compatibility? Where do you get image on compatibility?

MR. MAUTZ: I thought the two terms had been used almost synonymously this morning is why I used them, but image is certainly a problem of independence, yes. Especially the appearance.

MR. McCLOY: I think it was used in a different connotation.

I have a feeling that you have got a great asset in the public's mind and in your clientele's mind by the fact that you know your business. You know your main business. You don't want to dilute that.

MR. MAUTZ: That is right.

MR. McCLOY: That is a part of credibility. If you get the impression that you are just trying to pick up the bottom dollar wherever you can, then you lost a certain standing.

MR. MAUTZ: And it is the sort of thing that the market test will do for us only on a very slow basis over a long period of time. That is part of the difficulty.

The market will discipline the profession for us, but it takes a while to react to things.

MR. GARRETT: Mr. Mautz, will the market encourage independence?

MR. MAUTZ: I have no doubt of that.

MR. GARRETT: Is there a big market for more independence. You get more clients if you are more independent than if you are not?

MR. MAUTZ: Absolutely, but it takes a while for the absence of independence to become apparent, and it is not one of those things that is immediately visible.

MR. GARRETT: Is the absence of independence often something that management has sought to achieve?

MR. MAUTZ: I wouldn't accuse management of it, but that is one of the possibilities, yes.

MR. GARRETT: You can accuse them of it, but I think they tend to like it, it seems to me. When you get in trouble for lack of independence, it is because you have been playing games with management, isn't it?

MR. MAUTZ: One of the ways the public has demanded more independence is through the use of audit committees. That is a great factor.

MR. GARRETT: There might be a demand there?

MR. MAUTZ: Yes. That is one way of increasing the independence. I think, of course, our firm and the other firms as well have been enthusiastic about audit committees for that purpose.

MR. GARRETT: You heard Mr. Cardinal's statement, did you not, earlier?

MR. MAUTZ: Yes.

MR. GARRETT: With respect to the sort of fear that he was seeing through engagement in projects, particularly substantial projects, that would tend to generate a corrupt desire to want to make them look good or at least defer making them look bad and perhaps not report deficiencies as early as might otherwise be done, can internal procedures protect against that, if it is a danger?

MR. MAUTZ: I would say yes, they can. I think it would be a very, very short-sighted public accounting firm management that would lean that way at all in the long run. We would lose far more than we would ever gain.

I can imagine the conversation taking place, but I can't imagine any agreement: Well, let's try it this year and see if we can't push this off. We are going to have to face it sooner or later. If we have made a bust, let's face it and get it over

with. Clients don't appreciate us hiding our mistakes. If we have made them, we have to face up to them. The sooner, the better.

MR. WOOD: Could I ask what review you as the chairman or the senior partner or a couple of your close associates have of the audit that is conducted by one of your newer partners of the client engagement?

Do you require the partner who has completed an engagement to appear before a committee of Ernst & Ernst.

MR. MAUTZ: Are we speaking of an audit now?

MR. WOOD: Of an audit. We get away from MAS.

MR. MAUTZ: No, the partner in charge of the engagement, whom we call the client executive, will have the people assigned to him as staff complete the audit. He will review the work papers and the conclusions and approve them, and then we require a second partner review. That is, another audit partner who has had no relationship with that client is assigned to review the audit memorandum which spells out the various audit decisions that have been made and what we think are the sensitive and crucial issues, and to examine any work papers he feels necessary in support of the review memorandum and audit opinion.

He will make that review, and if he approves the work, that is the sum total of the review.

MR. WOOD: Why do you have him do that? Why is that partner reviewed?

MR. MAUTZ: There are a number of ways to respond to that question, but one of them certainly is to assure that he has approached these issues from an independent point of view.

MR. McCLOY: If there is disagreement, does it go higher?

MR. MAUTZ: Yes, sir. We have a policy memorandum--I mention this because I was just talking

about it to an MBA group the other day--we have a policy memorandum that provides protection for anybody on the audit staff, from the lowest level on up. If he has a dispute with his superior and his superior does not give him a satisfactory answer, he is required to take the question to the next level above his superior, and it marches all the way up until we ultimately get to the managing partner if necessary to provide a satisfactory resolution for the person raising the issue.

MR. GARRETT: Would you see some disadvantage to the reputation and the credibility of the profession if it got too far out in advisory services with some of the kinds that you say you wouldn't want to do?

MR. MAUTZ: Certainly. I can see any given firm might get itself so extended that it lost the reputation for a tight focus on its specialty that Mr. McCloy was talking about.

If that happened to any given firm, it hurts the whole profession. I don't think it is likely to happen.

MR. GARRETT: But you think other forces at least as far as self-regulation is concerned ought to be allowed to handle that problem?

MR. MAUTZ: I have, and our firm has, a great deal of faith in the market system. The market makes mistakes and it is slow to correct them, but so does regulation make mistakes. With a profession that is changing as ours is, and with a business environment that is growing as ours is, regulations that appear appropriate today may just raise the dickens with what we ought to be doing ten years from now.

It is very hard to repeal a regulation, and we can see that regulation could possibly prevent us from acquiring competence that we will badly need a few years from now.

MR. GARRETT: Do you see any harm in these two situations? One, your firm's revenue from MAS gets to be more than 50% of your total revenues, or with respect to a specific client, your aggregate revenues from MAS exceed your audit fee. Do either of those cause you any worry?

MR. MAUTZ: I don't think either of them cause me worry because of the other controls we have over independence. From an independence view I wouldn't worry about it. I think it is very unlikely to happen.

MR. GARRETT: You mean, no matter how successful your MAS gets, do you think you could still maintain your independent professional quality as an auditor?

MR. MAUTZ: The way we are organized, yes, sir.

MR. GARRETT: That is all I have.

MR. WOOD: Just one further question. The previous witnesses, particularly from the actuarial field, objected to a continuous service in MAS by CPAs.

Would you care to comment on that point?

MR. MAUTZ: You might do that better than I can, Tom.

MR. THOMAS R. TESTMAN: You are doing so well, Bob, that I don't think we should change.

MR. WOOD: In the actuarial field, for example, and it is in the appendix here.

MR. GARRETT: It is in the Executive Committee proposal.

MR. WOOD: That continuous service in the actuarial field would be objectionable. Do you have a comment on that?

MR. TESTMAN: I won't respond to it as it applies to the actuarial field because we are not

providing that service. The continuous service that I think is being referred to has to do with whether or not we are assuming a management role. We do not get ourselves postured so that we are involved in a management role.

We have a number of clients that we perform a large number of MAS projects for during a given year--thus we may be involved for several months with this client. We have other instances where a single project, particularly if it is a systems engagement, may well run for several months or even a couple of years. For these same clients, we may do very little consulting in subsequent years. I don't believe that is what is meant by continuous consulting. Again, in no case do we assume a management role.

MR. McCLOY: What is your chief field in the MAS area?

MR. MAUTZ: I am not in the MAS area. I am on the audit staff.

MR. McCLOY: I mean your firm.

MR. TESTMAN: We are heaviest in the systems area and in accounting, cost, budgeting, and financial planning and control. We have a number of individuals that have skills and disciplines in management science, industrial engineering, marketing (although not many in this area), organization and personnel and the like. We have a multi-disciplinary practice.

MR. GARRETT: How do you tell when a recommendation that you make on a systems project is your decision as against management's decision?

The suggestion was made that an adviser can produce recommendations that are tantamount to the decision, depending upon a variety of things, and I think we are all familiar enough with how that can be done.

How do you know when it really represents

a conscious management decision as against circumstances?

MR. TESTMAN: In our guidelines to practice, we make quite a deal out of the fact that we do not want to undertake an engagement unless we are satisfied that the client can successfully implement the engagement.

MR. GARRETT: What do you mean by that?

MR. TESTMAN: To implement an engagement means that they have to understand it. They have to have the competency and skills. They have to have the organization to make it work. It would not behoove us to go in and design a system if there was no one on the other end to make it work successfully. We have to live with our recommendations.

MR. McCLOY: You don't operate the system?

MR. TESTMAN: We do not operate the system. However, if it doesn't work, it obviously is going to be a reflection on our work. Therefore, we make every effort to assist the client in successfully implementing the system.

MR. MAUTZ: In many of our MAS engagements, I think our practice is to help the client get to where he can make a decision. We advise him what kind of information he needs, tell him how to gather it, tell him what he has to do, and show him the way to go about it rather than come to him and say: Here is our recommendation.

MR. GARRETT: At some point don't you get told to come in with a good system?

MR. TESTMAN: I would not say so. Obviously there are technical elements of a system that perhaps management is not in a position to make a sound judgment on. In that sense they might rely on us. However, management is the one that makes all of the significant decisions impacting the management function.

MR. GARRETT: If it is a financial control

system and the time comes in your management letter to comply with SAS-20 on significant deficiencies, who makes the decision whether to report a deficiency in control within your firm?

MR. TESTMAN: That would be the partner in charge of the audit engagement.

MR. GARRETT: Would he have had anything to do with the work in recommending the system?

MR. TESTMAN: He would have an oversight responsibility. Before we would undertake any work with a client, we would have reviewed and conferred with that partner in charge of the engagement as to the appropriateness of providing that service.

He would then on a continuing basis want to be satisfied that we were being responsive to that client and doing the kind of job that we said we would do. Generally, he would be not involved in any extensive way in the assignment itself.

MR. GARRETT: What I am getting at, of course, is the suggestion that if you had recommended the system, you would be reluctant to point out the deficiencies that otherwise should be pointed out.

MR. TESTMAN: I could not accept that. One of our arguments and our clients see it as a real advantage in systems work, is that we are very concerned and very responsive to the need for good internal control and good audit trails. I have seen other non-accounting organizations provide systems work that are not too attuned to that aspect. I think you will find a significant difference in this respect.

MR. McCLOY: You mentioned a number of things that tended to insure your independence. Can you mention any that you didn't mention before that you think could be added to insure this element of independence other than eliminating MAS? Are there

any other things that you can think of that this Board might recommend that would insure independence? Beyond what you are doing now.

MR. MAUTZ: I think the audit committee is a great development, but I fear that what we are tending to do now is perhaps overrate it, and there aren't enough trained people. I don't know that it would be your problem, but it would be very useful if we had some way of training audit committee members, teaching them their responsibility.

MR. GARRETT: How do you train a generalist?

PROFESSOR CARY: How about retired senior partners of accounting firms?

MR. MAUTZ: That is happening, yes. Our retired managing partners are on a number of audit committees already, and I think there will be more of this.

MR. GARRETT: Thank you very much, gentlemen.

MR. MAUTZ: Thank you very much.

MR. GARRETT: Now Mr. Henry Gunders of Price Waterhouse.

MR. HENRY GUNDERS: Gentlemen, thank you for the opportunity of making a statement on the issues which have been so well exposed in your Notice of your hearing.

I am Henry Gunders, a partner of Price Waterhouse & Co. and its Vice Chairman of Management Advisory Services.

I have been engaged in providing advisory services since 1951. During these twenty-seven years of practice I have seen much of the evolution of the MAS segment of the public accounting profession; further, I have twice served on the MAS Executive Committee of the AICPA, once from 1960 through 1963, and again from 1974 through 1976.

The scope of services offered by independent accounting firms has been a source of debate for more than twenty years. Some critics of the profession continue to allege that the mere performance of certain services, not considered traditional accounting and auditing services, impairs the auditor's independence.

Several independent investigations into this issue have been undertaken; we are aware of no evidence that has been uncovered to support these criticisms. But the criticisms continue. We believe they result in large measure from a lack of understanding of the real nature of the services performed by independent accounting firms and of the ways in which those services do--and do not-- affect a client's decision-making process. Further, the measures that accounting firms themselves have taken to safeguard their audit independence may not in the past have been adequately communicated.

We believe strongly that the public concerns surrounding this issue must be resolved. We have serious doubts, however, whether this is an issue that the profession should resolve itself through

joint action.

We recognize that the members of the SEC Practice Section have worked hard to attempt to identify those services that have been the cause of most concern. Moreover, they have set forth criteria that should be used, in their view, to judge the types of services that accounting firms should be permitted to provide to their audit clients. But we find ourselves in disagreement with the approach taken in the Section's report, in two fundamental respects.

First, we do not believe that it is either practical or in the public interest to make the profession's ability to provide services depend upon how those services are characterized--that is, as related to either "accounting" or "auditing." The scope of services offered by auditing firms should not be limited by some abstract idea of what is deemed "appropriate" for an accounting firm to do. Independence should be the sole test; only where audit independence would in fact be impaired should a service be proscribed.

Further, we seriously question whether the profession itself should attempt to limit the services offered to the public by its members. Any limitation on the scope of services offered by independent accountants would narrow the range of services available to the public. Moreover, our attorneys have advised that, if such a limitation comes about as the result of an agreement among firms that would otherwise be competitors in offering the restricted services, the antitrust implications are serious and cannot be ignored.

Because of the significant dangers posed in this regard, we believe that, if a limitation on the scope of services offered by accounting firms is to be imposed, it must come from outside the profession.

The AICPA has for many years worked closely with the SEC in developing specific examples to guide in performing advisory services, as related to the issue of independence, and should continue to perform that supportive role. These examples are available to and understood by members of the profession. As a result, the SEC is sensitive to the concerns of the day, and is able to deal effectively with the independence issue as it pertains to scope of services. Given these circumstances, it is abundantly clear that the SEC has both the needed background and the ability to set forth appropriate, enforceable guidelines for independence as they relate to scope of services.

Indeed, we believe that the continued public concern over the scope of services offered by the profession results in large measure from the fact that the SEC has not faced up to this issue. In September of last year, the SEC called for public comments to consider whether the provision of non-audit services impairs the auditor's independence. It did not decide that issue, however, or even establish guidelines for others to make the decision. Instead, in its recent rule, ASR-250, the SEC shifted the responsibility for making that decision to individual boards of directors or their audit committees.

ASR-250 requires audit committees to disclose whether they considered the possible effects on independence before permitting the auditor to perform non-audit services for the corporation. That portion of the rule was not even in the SEC's initial proposal and, thus, was not exposed for public comment. Moreover, while it purports to be simply a procedural rule of disclosure, ASR-250 may well have a devastating substantive effect--spilling

out the baby with the bath water.

Audit committee will obviously be reluctant, in the face of ASR-250, to state that they have not even considered the issue of independence. Thus, ASR-250 is, in practical effect, a mandate to audit committees to consider in advance of the engagement of an accounting firm whether the provision of any non-audit services will impair the firm's independence. But how are audit committees to make that determination? What specific guidelines should they apply? The SEC has failed to establish any. Yet at the very time the SEC is asking the profession to consider whether the provision of non-audit services may impair independence, it has in effect required individual audit committees to make that factual determination in advance, without any standards to guide their decisions.

Let me make it clear that we do not oppose the disclosures of advisory services to audit committees, investors, or the public. To the contrary, we strongly support the disclosure of all services performed by the principal accountant. We encourage audit committees to monitor closely the manner in which we perform those services to assure that our audit independence has not been impaired. Indeed, we believe that complete disclosure is critical to enable the public to understand the steps we have taken to safeguard our audit independence to ensure that it is never compromised.

But, as I have mentioned, ASR-250 is far more than a rule of disclosure. It places what seems to me to be an impossible burden on audit committees, requiring them, in effect, to make a factual determination in advance of an engagement without any facts or any standards to guide in their decision. It requires them to make their determination in a

vacuum. I do not think the SEC can fairly expect this of audit committees.

There is another reason why ASR-250 is fundamentally unfair. Accounting firms have been providing non-audit services to their clients now for many years. Any limitation on the ability of accounting firms to continue providing a particular service must be based on a comprehensive review of the years of existing experience and the determination that the service has in fact impaired independence. No matter how capable they might be, individual audit committees simply do not have the tools needed to undertake that review.

Evidence is already accumulating that ASR-250 will have an overbroad and "chilling" effect. Audit committees are reading ASR-250 as evidence of the SEC's hostility to the provision of non-audit services. Rather than risk criticism for making a "wrong" judgment, and having no standards to guide their determinations, audit committees may simply rule out the provision of any such services by the firm that audits their financial statements. As a result, firms may be barred from offering services to their audit client even though they are best able to provide those services and even though no threat to independence exists. In short, by avoiding the issue, the SEC may well have decided it--and done so in a way that is contrary to the public interest.

The scope of services issue raises important and difficult questions. The SEC has the responsibility to face those issues directly and to resolve them, not simply to finesse them.

In coming to grips with this issue, the SEC must keep firmly in mind that any restriction on the scope of services to be offered by the

accounting profession is anticompetitive. It limits the services available to consumers and restricts the number of firms competing to provide those services. If such an anticompetitive restriction is to be imposed--from whatever source--it must be based on the finding that audit independence will, in fact be impaired. Absent such a finding--absent proof that the provision of non-audit services presents a real threat to independence--there should be no bar to independent accounting firms providing services to meet consumer needs. And that should be so whether or not the services are normally considered or characterized as "accounting or auditing" services. Any bar not based on evidence that independence would in fact be compromised would be anticompetitive and detrimental to the public interest.

Making the profession's ability to provide services depend on what someone at some future time might consider "related to auditing or accounting," would place the profession in a strait jacket, and may well deprive the public of exactly those services that auditing firms are best and most economically able to perform.

Let me add a personal note here. Based on my more than two decades of experience in this field, I believe that the characterization of services as either "accounting" or "auditing" is simply irrelevant to the critical issue--whether audit independence may be impaired. When would--or could--a non-audit service threaten the independence of the principal accountant? Certainly not because the service is rendered by someone with expertise in a field other than strict accounting--for example, in engineering, mathematics or computer technology. Nor is a threat posed by the fact that the service bears on activities that take place outside the client's accounting department, let us

say, in the manufacturing plant, the warehouse, or the sales office.

The threat arises not from the type of service performed, but from the nature of the accountant's relationship to his client while providing the service. Recommending that a client's management take an operating decision--to build a new plant, market a new product, or acquire a new facility--these are the types of activities that would involve an auditing firm in the role of management, and may pose a potential threat to its independence.

It is not how the service is characterized, or even the type of service, but, rather, the accountant's involvement in the role that can only be management's that poses the threat to independence. What are needed, in my view, are not arbitrary proscriptions of particular services, but clear definitive standards that will serve as guides in performing all services, to assure that independence is not compromised.

Moreover, I must emphasize again that, when the SEC examines this issue, it will not be writing on a clean slate. As I mentioned before, accounting firms have been providing non-audit services for years. A substantial reservoir of experience exists that may be drawn upon to determine whether the provision of any particular service has in fact impaired audit independence. Any restrictive regulation by the SEC must be based upon this extensive experience, and not upon surmise or speculation.

For example, in the notice of these hearings you raised the question of the possible impact on independence that might flow from the performance of tax services. And, you asked whether a distinction should be drawn between them, and other advisory services.

The rendering of tax services to clients of

our firm is the responsibility of the Tax Department, and, therefore, I cannot reply with the same background of experience as is the case with management advisory services. But I believe that tax services may perhaps provide the best example of the need to examine the experience of which I have spoken.

Bear in mind that the one main feature of tax advisory services that distinguishes them from other advisory services is the existence of an external and independent review mechanism unrelated either to the auditor or the client. All tax advisory services are conducted within the context of rules, regulations, and interpretations established by the particular taxing jurisdiction, and the results of actions taken by a client in response to tax advisory services are subject to adjustment based on an external government review. This special feature, in my view, virtually eliminates any threat to the auditor's independence.

More important here, however--that view is borne out by experience. As the Cohen Commission Report noted, whatever potential conflict might appear to exist is contradicted by the years of actual experience. After 60 years of experience in providing tax services, no independence problems have occurred.

To set my comments today in the proper context, I believe it is important to mention the limitations Price Waterhouse has imposed on its own practice. Let there be no misunderstanding here--we are not advocating caution in limiting services because we at Price Waterhouse want to offer the widest possible variety of management advisory services to the public. Far from it. Seven years ago Price Waterhouse adopted perhaps the most

restrictive policy of any of the major independent accounting firms with respect to management advisory services. We do not undertake any assignment that would place any responsibility upon us for making or recommending commercial decisions to management. Moreover, we do not engage in actuarial services, market analysis, product analysis, plant layout, or product pricing. We imposed these limitations upon our practice because we believe they are appropriate for Price Waterhouse.

In summary, we believe it is inappropriate for the profession, or for the Public Oversight Board on behalf of the profession, to limit the services to be provided by independent accounting firms. The decision to proscribe services must be made, if at all, by the SEC, and only on the basis of its own factual determination that a particular service has in fact impaired audit independence.

Moreover, we recommend that the Public Oversight Board, and the Institute, petition the SEC to withdraw that provision of ASR-250 which, in effect, requires audit committees to determine in advance whether the provision of non-audit services might impair independence. We urge the SEC to come to grips with this issue itself.

MR. GARRETT: Thank you, Mr. Gunders.

MR. McCLOY: Who are your lawyers?

MR. GUNDERS: Arnold & Porter

MR. McCLOY: Maybe we ought to retain them.

(Laughter)

MR. GUNDERS: Conflict of interest.

MR. GARRETT: If we can't get them, we might try Milbank.

MR. STARK: I was going to ask if your lawyers have prepared a memorandum on this topic that would be of interest to the POB that you would want

to submit?

MR. GUNDERS: Just a comment that I would wish to submit; I believe that antitrust was a consideration which was given to our position with respect to the Metcalf inquiry.

MR. McCLOY: How would the SEC be any better equipped to decide this question than the audit committee?

MR. GUNDERS: For a number of reasons. The SEC has had a constant stream of specific inquiries such that if we do this, for example, if we maintain a computer service bureau, will that allow us to remain independent or not. It is a methodology which I will call making case law. You will be relieved that I am not an attorney, but I do believe that is in tune with our system of jurisprudence in this country. I for one think it has served the profession well.

Were that not to be the case, in the litigious climate of today, it is strange that there would have been no third party litigation.

MR. GARRETT: I am beginning to wonder who voted for the Executive Committee proposal. Do you happen to know? (Laughter)

MR. GUNDERS: Yes, I know.

MR. GARRETT: Those other guys, whoever they are.

Any other questions.

PROFESSOR CARY: I take it this is consistent with Price Waterhouse's position and the Metcalf Committee in that you believe fundamentally in government intervention more than leaving it to self-regulation.

MR. GUNDERS: Not so, sir.

PROFESSOR CARY: In a sense this is what you are suggesting. This is short of government intervention,

i.e., via the SEC.

MR. GUNDERS: This suggests no legislative action.

PROFESSOR CARY: No, but it does suggest movement.

MR. GUNDERS: This suggests the translation, if you will, of the case law made by the SEC with respect to independence provisions into a set of standards.

PROFESSOR CARY: I don't think they would yet say that they have made a clear cut sort of set of standards via case law yet, so therefore, it would have to be, it would seem to me, a set of rules, you might say, rule making.

MR. GARRETT: They haven't in this area. I presume they imagined it was a little too sensitive. In some other, they have, as you know, restated a series of interpretations into the guidelines that have been published over the last couple of years, but those perhaps probably fall short of what some of the more stringent ideas are within the Commission, and it doesn't seem suitable for that treatment right now.

PROFESSOR CARY: Is there any evidence that leaving this, as you have pointed out, in the hands of audit committees via ASR-250, has actually already had an impact on, shall we say, a decision by those committees, and therefore by their companies, to shift from one auditing firm to another because it is engaging in management services?

MR. GUNDERS: Yes; that evidence is limited because the final rules are hot off the press, so to speak. But, as Mr. Garrett has pointed out, the audit committees are themselves making case law because it is necessary in their proxy statements to set forth what prior consideration they gave to

the engagement of their principal accountants in rendering their audit services; so, under those circumstances, each and every audit committee whose accountants have performed anything defined as non-audit services obviously must deal with the problem, and deal with it now.

MR. WOOD: That is, effective with annual reports, sir, September 30.

MR. GUNDERS: September 30 is not here yet. But the drafting is hard upon us.

PROFESSOR CARY: Therefore, in theory, at least, the companies will be moving toward your firm and one or two others one could mention because they have most scrupulously avoided a broad range of management advisory services. Isn't that right?

MR. GUNDERS: I think that would have to be conjecture. I really can't say.

PROFESSOR CARY: It seems to me if they have moved from somewhere, they now have to move to somewhere else.

MR. GARRETT: Would you drop the firm or just drop a service? It could be either.

PROFESSOR CARY: In other words, they could drop the service in respect of that company. That is right.

MR. GARRETT: Unless the contamination is beyond that kind of treatment.

PROFESSOR CARY: That is right.

MR. GUNDERS: Let's examine the issue in this respect. I think both colleagues and competitors sitting back of me would readily agree that a great many management problems which will yield to solution with better accounting data are not diagnosed by the client. They are diagnosed by the accounting firm. They are diagnosed by the accounting firm to the extent by which the accounting

firm is able to penetrate the facts at hand, and in a sense, flush out the problem.

To some degree, the interplay which I foresee, broadly, and have specific evidence as yet very narrowly,--I can count the cases on the fingers of one hand at this point--run something like this. Usually the authority for engaging an accounting firm to render management advisory services will be located within the management advisory services will be located within the management structure, setting aside those circumstances where the size of the engagement would throw it into the purview of the audit committee or the board of directors.

Under the provisions of the ASR-250, two interesting and potentially far-reaching new issues fit into this particular picture. The first involves a statement with respect to the need for a particular service such that that need becomes known to the audit committee. This is an extremely legitimate area of concern and one with which, I repeat, we have no difficulty whatever.

It is our considered view that the appearance of independence or, if you will, noncompatible services, to the extent that an audit committee member can deal with a particular issue with understanding and prudence, will yield only to education because appearance is in the eyes of the beholder.

MR. McCLOY: You said the audit committee had no equipment to deal with this.

MR. GUNDERS: I think, sir, by and large the audit committee does not have equipment to do it. I will define such "equipment" as being, first, a series of do's and don'ts if you will, and second, as having a broad base of past experience.

The latter can be gained by case law over a period of years as it develops in a given company, and by a retrospective view of what has, in fact, been done by the accounting firm over years past in evaluating whether that did or didn't threaten independence as proven out by the facts in the intervening years. The first, we recommend, should be the standard setting, as a responsibility of the Securities and Exchange Commission.

MR. WOOD: It seems to me that your position opposes self-regulation.

PROFESSOR CARY: That is my view, too.

MR. WOOD: That is what we are here for, it seems to me, and what you are saying, in effect, is that the industry, your profession, should not regulate itself on this question of services. It should be controlled by standards uttered by the SEC.

MR. GUNDERS: Might we not regard what I have said in a somewhat different context? The SEC would determine, as it consistently has done in the past what, in fact, constitutes a threat of a loss of de facto independence. I go no further.

The profession would regulate itself, having those standards available for interpretation, and then subjecting the practice of each and every firm to peer review, and all of the other mechanisms which the SEC division of firms contemplates; so I draw a line, if you will, between the promulgation of an interpretation of when an accountant is, in fact, independent, and the monitoring of that independence.

PROFESSOR CARY: Except that the SEC generally makes its rules by cases, and therefore, it has to take action in order to generate those

cases, and therefore, you are assuming the way you are approaching it that it is likely to be that it will not only be just setting up a rule but also taking positions in court and what-have-you in order to develop that set of standards.

That is the way the SEC certainly has operated as you well know recently in improper payments and what have you.

MR. GUNDERS: I am not certain that we have a perfect analogy as between the improper payments issue and the independence issue. Maybe the SEC independence rulings which we read about in the profession deal with a particular set of circumstances that some practitioner has brought before the SEC; thus, he might say, "Under these circumstances, if I render these types of services to a client, will that endanger or threaten my independence as principal accountant? And the SEC then takes a position.

It seems reasonable that one could distill principles from the case law that has thus been created over so many, many years.

MR. WOOD: If I follow you correctly, you disposed of appearances of independence and came down that only fact, only history, case, facts on the compromise of independence should govern the SEC, or govern the establishment of proscriptions of services.

Am I correct so far?

MR. GUNDERS: The SEC has in the past provided advisory comments which are based on a set of factual determinations placed before it.

The second part of your statement in which you refer to, I believe, individual scope is one which we would feel could be appropriately determined by each particular set of the parties of interest,

having in their possession these standards of independence.

MR. WOOD: But getting back to this question of appearance, the SEC has indicated in what I have read that appearance of independence is very important. How can you hope that a petition by the AICPA and this group, the POB, to the SEC is going to detour their thinking or rearrange it, so that they will come down only on the side of the factual records? They are already on record as saying that the appearance of independence is threatened--I mean, they have implied that. Perhaps the Chairman hasn't come down that way yet, but it seems to me that you ought to face that question before you resolve it so clearly that it is up to the SEC to do.

MR. GUNDERS: I have Chairman Williams' remarks very closely at heart, all of them, including the most recent ones, and I suppose I would have to echo what Bob Mautz said a few minutes ago. In dealing with an issue of this nature, one can deal with it in terms of how one perceives reality; or one can deal with it in terms of appearance, and also in terms of political, or if you will excuse the expression, cosmetic aspects.

I would hope that it could be dealt with in the former regard only.

MR. WOOD: In real terms.

MR. GARRETT: To say that restrictions would have to be based upon a factual finding of loss of independence is really saying that there will never be any restrictions except in perhaps the most extreme cases.

It seems to me to resemble very much the development of the profession's attitude about independence and financial interest, and that one of the statements that we received I think described this in summary fashion very well, and the argument

was early made that if independence is a state of mind, that is something ultimately known only to the person whose state of mind is material, and it certainly isn't determined by whether he does or does not own a hundred shares or a thousand shares of stock or has some other little interest in the company, he is still quite capable of being independent.

The profession didn't buy that for pretty good reasons. In fact, it perhaps overbought the opposition by taking an extremely strict view with respect to what kind of financial interest contaminates or impairs independence, at least, under the rules, not in fact in terms of what is in the person's mind. There are plenty of people that are capable of ignoring the effect of their actions upon the market value of 100 shares of stock.

Congress has trouble understanding this with proof of government appointments, too, but it seems to me that if there are to be any rules in this area, they really cannot be based upon a finding of specific cases in which you can demonstrate through direct causal effect the provision of a management advisory service and a loss of independence.

You won't know about the loss of independence until you see something else that has gone wrong, namely, that the auditors in some way have been deficient, and even then, you won't know whether it was really caused by the management advisory service or not. If that is cosmetic, I think if anything is to be done in the area, it really has to be done on a conviction that certain things would appear to create, as one of our earlier speakers said, the proximate occasion for sin or something of that sort, something that ought to be

eliminated in a prophylactic way because the temptations are too great and the experiences bad, just as you say you can't own 100 shares of stock.

If you are saying that the present standards are all right, there is more regulatory type law here than we know about through a collection of these interpretive opinions that have been received on particular cases by the staff, maybe those could be codified or at least made known more broadly, and out of those we could construct a sort of a restated common law of management advisory services as they relate to independence, and that is perhaps enough.

Maybe it is. I don't know what we would get out of all of those opinions because I don't know what is in them. Certainly the political case is that something more needs to be done. What we are trying to decide is whether we agree with it.

MR. GUNDERS: I think that is certainly the case.

MR. GARRETT: It is different now than on previous occasions because not many people have gone to the staff to ask whether they could pay a bribe or not. A few have.

MR. GUNDERS: To your knowledge, Mr. Garrett, has the SEC undertaken a searching inquiry to determine whether some standards of independence can be distilled from all of these opinions that have been promulgated throughout the years?

MR. GARRETT: I do not know.

PROFESSOR CARY: I would like to ask one other question.

In view of the fact that this is totally in another area, but in view of the fact that Price Waterhouse over the years has carefully, as you have pointed out, avoided many areas of what fall within the category of management advisory services, can you

give any rationale for it. Does it carry so far as to raise a question whether these other firms should be engaged in it?

MR. GUNDERS: I think that question was probably dealt with in the Metcalf testimony as well as I could deal with it here; in that testimony we made a rather strong statement that we felt under no circumstances should that scope of services which we have chosen ourselves become any sort of a standard for the profession.

The reason that we have restricted our scope as we did is based on our own perception of the kind of enterprise that we want to be, and the kind of services that we choose to render.

There is a great deal to be said in any enterprise for being very clear about what function one wishes to serve, and trying to be as competent as one can at rendering that function, and that function only.

MR. GARRETT: If, accepting for purposes of argument, that the Board should advise against any limitation on services based on the concept of compatibility or accounting-and audit-related skills or areas, and recommend that the problem be addressed only as a question of independence, is there anything that could be achieved in a constructive way by way of guidelines by which peer reviewers might examine with respect to the reviewed firm for the furnishing of services and the possible effect on independence? Is there anything in that area that would be helpful?

MR. GUNDERS: I can see two possibilities. One which you mentioned earlier, which would be the best possible set of statements with respect to indicia of independence which must be present, culled from past SEC experience, and the other one

would be possibly something similar to that which we accountants have insisted our legal friends provide to us in connection with an audit, and that is an "independence" letter.

MR. GARRETT: An independence letter from the lawyers?

MR. GUNDERS: No, from the accountants.

MR. McCLOY: Saying what? What does it say today?

MR. GUNDERS: It could set forth a scope of services which is consistent with independence as stated by the SEC.

MR. McCLOY: You haven't got that statement from the SEC yet, have you?

MR. GUNDERS: No, sir.

MR. GARRETT: Obviously, the SEC doesn't know what it thinks or it would have said something. There is considerable debate as to what its current views are.

Now, what is has said it has collected from past interpretations. Certainly for the last decade or so they are available.

MR. GUNDERS: Yes, they are.

MR. GARRETT: Has anybody done that sort of job, a restatement job on those letters? I suppose some firms have on particular areas.

MR. GUNDERS: I suppose as an intellectual exercise it is something which holds some promise of being useful, yes.

MR. GARRETT: I have some hesitation about glorifying that kind of expression from the staff into law, but maybe it would be helpful.

MR. GUNDERS: Or rules.

MR. GARRETT: We know what the rules are.

MR. WOOD: May I ask a question. Does ASR-250 require an audit committee to approve, before

the services are rendered, MAS services hereafter?

MR. GUNDERS: Yes.

MR. WOOD: Or only to review MAS services that have been performed, let's say, in the preceding year.

MR. GUNDERS: Mr. Wood, the initial September, '77 proposed ruling which went out for public comment and exposure, called only for the latter. In other words, it was incumbent upon an audit committee to satisfy itself as a matter of review that the services of a non-audit nature performed by the principal accountant did not endanger that accountant's independence.

The final rules, which were issued without comment, revised that in two respects. One, which you have named, is that prior approval is now required. The second one requires that prior approval be provided in each individual instance. As to that second part, I must say I have some personal difficulty as to its practicality because many audit committees meet perhaps only once or twice a year.

MR. WOOD: You put your finger right on it. They would have to meet whenever. Management would have to alert the audit committee that it was proposing to accept a new service from its auditing firm, and that would require lots of attention to a new subject.

Thank you. I will adjust my schedule as an audit committee member.

MR. GUNDERS: As you know, the down-stop is 3% of the audit fee. That is a rather fine mesh.

MR. GARRETT: Obviously, you should increase the fee.

MR. GUNDERS: I don't think that is the solution our clients are looking for, Mr. Garrett.

MR. GARRETT: I think we had best move on. Thank you very much, Mr. Gunders.

Mr. Seitz.

MR. JAMES E. SEITZ: My name is Jim Seitz. I am the partner in charge of the Los Angeles office of Touche Ross & Co. Prior to this assignment I spent a great deal of my professional career in the management advisory services area of our firm.

By way of background, I have served on the Board of Directors of the AICPA for a period of four years. I served on the Management Advisory Services Committee for a period of four years. I was Chairman of that Committee for two years. In addition, I served on the Scope and Structure Committee of the AICPA, which produced an excellent report. If you gentlemen have not had the opportunity to review that, I would urge you to do so. I think it deals directly with the subject at hand.

MR. McCLOY: What is the report?

MR. SEITZ: The report on Scope and Structure for the accounting profession.

Because we have submitted our written report, and in view of the time of day, the lateness of the hour and the issues that have been raised, I will deal with issues that I think are paramount to your interest as I have heard expressed today. Of course, I will respond to any questions that you might have.

Mr. Garrett, we were one of the firms that voted for Amendment B.

MR. GARRETT: You are very welcome.

MR. SEITZ: As I understand it, 13 of 21 members of the Executive Committee did so, and we were one of those 13.

MR. GARRETT: That is close.

Do you have any more insight as to who was for and who was against, big and little, national, regional?

MR. SEITZ: I think the real answer is only a partial insight, and I don't think that is appropriate

to report on that at this point in time.

MR. GARRETT: We have been told all that sort of thing is available to us.

MR. SEITZ: I am sure it is.

I think what's most important for you gentlemen to understand is that we voted for this because we thought it was perhaps the most realistic, pragmatic solution available to the profession at this point in time. Interpreting that another was is that we don't like it, but we like it better than what we thought were available alternatives.

Mr. McCloy, I gathered from your questioning this afternoon that in a sense you are seeking some advice and counsel from us as to what this Board should do relative to this whole sticky issue, and at the risk of being presumptuous, I will give you my point of view on that.

I think that the only safe road is to have a conceptual framework which is logical and rational that people can live with. I think the only thing that I haven't heard today which to me is very important is that management services in CPA firms is not like a conglomerate. We don't get the next best available service that looks as though it has marketability and then bring it into our home and make a profit on it.

As a practical matter, the way a professional firm evolves, is that you start with a core service and then you add adjacent services to that as the marketplace, the economic conditions and the time and place warrant.

Within the public accounting profession over the last 10 or 15 years, we have had a propensity to add two types of services, those that become more quantitative and those that become

more qualitative as the marketplace demands. Each service tends to, if you will, open up new vistas and new requirements, and you get a fan effect from your core service on each side, quantitative and qualitative.

The important fact, is that there is a servo mechanism that stops us--stops any firm--from going beyond, to extremes that do not have a rational cause, and although that servo mechanism is hard to describe, it is very important.

Mr. Auerbach, for example, said he had, if I recall correctly, 9 partners in executive search in his firm. I don't know the exact number of people in Coopers & Lybrand in the U.S., but I would suspect it is in the neighborhood of 8,000 to 10,000 people.

Now, why does he have 9 as opposed to a hundred or five hundred. I am not being presumptuous, I just want to use this as an example.

The way a CPA firm behaves in this day and age is that there is a need for 9, but there is not a need for a hundred. A hundred would not find a comfortable home in that environment. Their home would be more comfortable in other environments, so you have a mechanism that allows for that.

Similarly, if we brought bookkeepers into our firm, they would become very uncomfortable in the firm because they would not be part of the group. They would not be in the nucleus and the hub of what we do, and they, too, would fall out.

This is very hard to describe to Congress. It is very hard to describe to audit committees. It is hard to describe to people who haven't lived with the function, but it is a reality, and somebody hopefully some day can articulate that so that an informed public will understand.

Let me relate this concept to the Amendment

we endorsed. We think this amendment is based upon the realities and the exigencies of the day, thus, we voted for it.

With respect to both the fact and appearance issues of independence, I can no longer deal with appearance. I don't know how to deal with it. It is a witch hunt.

The proscriptions that are placed upon us are very real. They are legal and marketing proscriptions. If we do something wrong, we are going to get sued, and if we don't do something well or if we are not as good as our competitors, we are not going to have a place in the market.

I think that is terribly important to recognize, and I would really urge that this thought be emphasized in all of your deliberations.

Another thing hasn't been said. Those of us who live with the audit partners know they are living in a very tough world these days. If you assume they are Mr. and Mrs. Average American, they are not going to be intimidated by something that will cause them to impair their independence because the buck stops there. If they are wrong, they will go to jail, and we have to recognize that. So as a practitioner consulting within a CPA firm, I can assure you I speak for all of my partners. Our audit partners are nonintimidatable, as far as I am concerned.

Will you have a rotten apple in the barrel as Krushchev said? I suppose we will. I don't think we are going to be a perfect profession, but I think the pressures that have been placed upon us these days are very healthy and I am happy with them.

As to the quality of audits, I think all of you gentlemen would agree that we are under

pressure to improve, and we cannot improve by eliminating the things we need.

The way the GAO audits has previously been discussed, I think that process is a forerunner of what is ahead of us in the private sector.

One of the questions you asked is what are the probable effects in the business community if management services went away. Basically, I think three things would happen. One, business would be short of a supplier of professional services that they have shown they want. Two, to reiterate, I think the quality of audits would deteriorate over time, and three, most importantly, over time, probably within the next ten years, you would see a general diminution of the quality of the people that enter the public accounting profession.

For those of you who haven't been on campuses for a number of years, I can assure you that the things that the top, young, bright leaders of tomorrow want is to work in an environment that is challenging, that is not restrictive, that it not sterile, that permits them to open their horizons. The more you contain disciplines, the more you attract mediocrity, the less attractive the profession will become. I would rather have a full scope service and take the risks that go along with it than have a limited scope service and do a poor quality job over time. I think that is the choice we face. We have trade-offs that we have to make.

Your last inquiry about the distinction between tax and MS was almost an unfair inquiry as it is so difficult to answer. I think if you listened, as I have, you got no answer so far on that particular issue. We don't know how to answer it. Taxes are an acceptable part of

the accounting profession. It has a formal structure. People don't even want to ask the question. It becomes embarrassing. But, when you relate it to other advisory services, then you either have to throw the baby out with the bath water or say the logic has to be applied in a different way to other advisory services.

I would concede and concede totally that the format of the tax structure, the review by IRS and so on, do make it somewhat different, but in the final analysis from a conceptual point of view, I think there are very strong correlations.

In closing I would like to suggest this. It seems to me today is not your concern, but rather, it is important that you be sure that five and ten years from now we have the right mechanism in the accounting profession.

So you might have to swallow hard, make some tough decisions, but to be certain that ten years from now we have the auditing profession we need in this country.

MR. GARRETT: Thank you very much, Mr. Seitz. Gentlemen.

MR. McCLOY: I don't know that I have any questions. How deeply are you, Touche Ross, in the MAS business?

MR. SEITZ: In response to your question, it represents approximately 15% of our dollar volume.

MR. McCLOY: Do you do executive recruitment?

MR. SEITZ: We did, sir, and within the last six months to a year we eliminated that from our activities.

MR. GARRETT: Would you tell us why?

MR. McCLOY: What are your main areas?

MR. SEITZ: We are not at all unlike E & E as Mr. Mautz reported. Basically, we concentrate in

the areas of financial planning, organization, administration and control, systems activities and derivatives thereof.

MR. McCLOY: Do you do engineering in any form at all?

MR. SEITZ: Engineering is a very broad word, Mr. McCloy.

MR. McCLOY: I am talking about layouts.

MR. SEITZ: I would suggest this, sir. The engineering that is typically done in 99% of CPA firms is really in the field of industrial engineering, and since industrial engineering and accounting are so closely related these days in the college environment, it is very hard to separate the two.

That relates to such things as: how the job gets done, inventory control, production control, these kinds of things. Productivity improvements, if you will.

MR. MATUSIAK: Would you explain to us the actuarial services that Touche Ross renders?

MR. SEITZ: As a practical matter, we have not been in the actuarial field very long.

MR. MATUSIAK: There is a group called Touche Ross Stennes?

MR. SEITZ: That was a joint venture. That has been disbanded, and we are in the process, as I think E & E reported, of adding in-house actuarial talent at this point in time. Again, part of this spectrum of requirements we feel we have to have.

MR. GARRETT: One of the problems that keeps arising with respect to the Executive Committee proposal, I am sure you know, has to do with this auditing-and accounting-skills related question and some challenge of its relevancy as a matter of logic and reason. Others would say: Even if it makes sense, it is so open ended that it isn't

really a control at all, if an audit-related skill or some sort of skill is useful to you in the conduct of an audit.

Do you have any helpful answer for us?

MR. SEITZ: I have some thoughts. I don't know how helpful they will be, Mr. Garrett.

I remember many years ago there was an article in the "Journal of Accountancy" by Herman Bevis. This article could have been written ten or fifteen years ago. You might recall it, Lou. The thrust and essence of the article was the accountants requirements and ability to deal with economic data. Let me editorialize from that point on.

If you really look at what we are trying to do as accountants in this society, it seems to me that what we have is a common language of business which we ought to be very proud of because it must have been an enormous breakthrough to come up with something like that. That language of business has now become a translator of economic data, all kinds of economic data from the floor of the shop, from the advertising department, from the research department into a common denominator we call dollars or money or whatever the case might be. Frankly, I don't want to try to suggest that I am a semanticist and know exactly what auditing skills and accounting skills mean, but from a deep set of convictions and from a long history of dealing in this field in my judgment you cannot deal effectively as accountants unless you are able to deal with economic data of all types and translate it properly. It seems to me that if all we have in the accounting profession are translators as opposed to understanders of economic data, we have nothing at all and we end up to be a bunch of eunuchs.

MR. GARRETT: I understand that. I have

two questions.

One of them is commonplace in the discourse, but I still want to put it. The one that I hear the most often is: Well, if you need actuarial skills in order to effectively audit a company that has actuarial elements in its financial statements including pension plans, and that justified having actuaries and actuarial services, why isn't the same thing true with respect to geologists or oil and gas engineers if you are auditing an oil company, and move on from there to any sort of company you want to select.

Secondly, granted, if it is true that you need to understand actuarial science to some degree to audit an insurance company, why does that mean you have to sell it as a separate service?

MR. SEITZ: Let's deal with the first question first, geologists and so on.

Again it seems to me, and I think I will pattern an answer after one Mr. Gunders made, that it is totally contingent upon the firm that you have decided to be the services you have decided to render and the industries you have decided to serve.

If, for example, one decided to set up an accounting firm that dealt solely with the oil and gas industry and they were going to be the experts in that field, there is probably a more prima facie case available for having those skills that relate specifically to the industry expertise, be they geological, or whatever the case might be.

From our point of view, we would have absolutely no rational business reason for putting those types of skills into our organization if we didn't have that kind of clientele. I think you have to take specifics and deal with them, and I would reiterate that you have to get back to the concept of a spectrum of services that make sense

for the marketplace that you are dealing with.

MR. GARRETT: The only difference you would draw between actuarial services and oil and gas engineering would be the nature of the concentration of your business?

MR. SEITZ: No, sir, I think there is one other basic distinction, and that is that the data and the type of data you are dealing with and its direct total impact on financial statements of actuarial services is, in a sense, in this day and age, a bit different than the geological data that you are dealing with as it related to reporting on oil companies.

I think there is a direct one-to-one correlation right now which is not quite existent in the other examples that you make.

MR. GARRETT: Because of the intellectual faculties necessary to understand?

MR. SEITZ: Because of the nature of our balance sheets right now and what is required to be reported on down the line.

I think there are subtle differences there, quite frankly. I don't pretend to be an expert in the oil industry.

MR. MANZONI: In adding actuarial services or starting to add actuarial services, was that done because you feel that it is necessary to do something other than rely on the competence of the actuaries performing actuarial services for clients whom you audit?

MR. SEITZ: I think the answer that does depict our policy in that regard has two parts, one of which is that we are developing a very good sized practice in the insurance industry, and secondly, as a result of that, we want to do the best job for the industry we can and that includes having in-house

actuaries and understanding it as well as we can.

MR. MANZONI: So is there something to the argument that there is a self-review if the auditors actuaries, perform primary actuarial services?

MR. SEITZ: I think the answer is yes, but--. The review that the auditors would make of the actuaries is a different form or review than the actuaries would make themselves.

Secondly, I think it might be appropriate to answer a question which you didn't ask which related to the quality control services within our own firm as was asked of another firm.

We, too, have a general services partner who is in charge of each audit engagement. There is an outside second partner who reviews the work. We have a professional standards review function within each office or within each territory that independently reviews the work. We have regional technical centers located around the country. When any issue comes up that is debatable, it is passed through the technical center. We have an appellate court procedure within the firm which begins with the partner on the job and goes to the managing partner of the firm. Thus, this whole review process even as it would relate to actuarial services at this point of time, would be touched by those mechanisms if such mechanisms were required. Therefore, I would suggested that simply using the word "self-review" is maybe not quite adequate.

MR. MANZONI: It seems that what you are saying is that you have such good procedures that you ought to be able to perform all sorts of management services whether they are advisory or whether they are primary because you have very good control procedures internally.

MR. SEITZ: Be definition and design, all the services that we perform in that area are advisory.

MR. MANZONI. What about actuarial services?

MR. SEITZ: I think if you recall the points made in, I think it is appendix B of your document, we have subscribed to those precepts in that context.

MR. MANZONI: Do you perform actuarial services for ERISA plans?

MR. SEITZ: Yes.

MR. MANZONI: We were told earlier when you are performing actuarial services for the ERISA plans, the actuary has to make the determination rather than management.

Could you elaborate on that a little bit?

MR. SEITZ: You are asking the wrong man very technical questions in an area I really don't feel equipped to comment about, quite frankly.

MR. McCLOY: I will put just a couple more questions. Is there anything that you can think of that we might recommend? I won't say proscribe--that we could recommend which would better insure the independence of the accountancy firm that are not now being applied? That is one question I have, and the other is I would like to have you tell me whether you have a set of principles in Touche Ross which prescribes the conduct of the accountants in their relations with the corporations.

Do you have an ethic in the form of principles in terms of your relation? You don't own stock in the particular companies, do you?

MR. SEITZ: No, like all other public accountants, we don't own stock in the companies we audit.

MR. McCLOY: Is there a set of rules that you apply as to joining the same clubs? What kind of gifts can you accept? Do you have any such principles?

MR. SEITZ: Neither a lender nor borrower would be one precept.

Can you join clubs? You betcha. You know, we are only on this earth one time as far as we know, and we are going to enjoy it in that process. I think we would be just absolutely foolish to become monistic in this whole process. What are our principles?

MR. GARRETT: Unless you could find a club where you didn't have any clients. (Laughter)

MR. SEITZ: Those are hard to find these days, but Mr. McCloy, we talk with the audit committee these days about everything we are doing and why we are doing it and how it stands, and we do that on anything significant quite clearly. So, I think the name of the game these days is open and above board. Putting the cards on the table.

MR. McCLOY: There is no other principle you think we could endorse that would be helpful toward the maintenance of the objectivity and the independence of the accounting firm?

MR. SEITZ: I could suggest that the better the people you get, the more independent you are, these kinds of things.

MR. McCLOY: There is no mechanic?

MR. SEITZ: I can't think of one offhand, no, sir.

MR. GARRETT: Thank you very much, Mr. Seitz.

MR. SEITZ: Thank you

MR. GARRETT: Professor John O. Mason.

We are glad you could stick with us, Mr. Mason. Please proceed.

PROFESSOR JOHN O. MASON, JR.: I appreciate your letting me appear at this late hour.

I am John Mason. I am a Professor of Accounting and Information Systems in the School of Accountancy at the University of Alabama.

I have been a professor for a number of years. In addition to being active in the academic community, I am active in consulting work, participating on cooperative engagements with several local CPA firms, both in Alabama and in West Virginia. I also consult in my own name.

I am active in the Alabama Society of Certified Public Accountants and have served as Vice Chairman of its MAS Committee. I have also served on one of the MAS subcommittees of the AICPA.

Some consultants might refer to me as a moonlighting consultant. On the other hand, some of my academic colleagues, hopefully tongue in cheek, refer to me as a moonlighting professor.

In addition to my relationships in academia and in practice, I am Chairman-elect of the American Accounting Association's MAS Section. The American Accounting Association is the umbrella association for professors of accounting. It is actively supported by members of the public accounting profession.

The MAS Section is a special interest group within the American Accounting Association, and it has approximately 400 members. Though I am an academician and serve as Chairman-elect of the MAS Section, I cannot speak for all academicians or for that matter the 400 members of the MAS Section.

The views I express here are mine alone. They do not necessarily represent those of the American Accounting Association or its MAS Section.

MR. McCLOY: Only academicians belong to this American Accounting Association?

PROFESSOR MASON: No, some practitioners belong to the American Accounting Association, but I would say that for the most part it is run by academicians.

One of my primary purposes in being here is to put in perspective some of the academic comment that has come forth in the last several years relative to public accounting and management advisory services.

But let me return to Public Notice 78-1, in which the Executive Committee of the SEC Practice Section has proposed two criteria for management advisory services: One, independence; the other, skills relating to accounting and auditing.

Although I agree with the committee's independence criterion, yet I disagree somewhat with its juxtaposition of "appearance of independence" to MAS, I strongly oppose the proposed criterion that the SEC practice member will "not undertake an engagement for its audit clients registered with the SEC where...the skills required are not related to accounting and auditing." The reason I am opposed to this criterion is that I don't think it is practicable.

The old adage: "Beauty is in the eyes of the beholder" applies to the Executive Committee's accounting and auditing related criterion. What may be "accounting and auditing related" in one person's view may not necessarily be "accounting and auditing related" to another person. For example, some individuals might make the case that any decision process leading to the authorization of a transaction of any type is accounting and auditing related. Therefore, any advice that a CPA would contribute to such a decision-making process by management would be accounting and auditing related. This would be one end of the spectrum.

At the other end of the spectrum stand those who insist that accounting and auditing related services are those dealing with the design of an accounting system. Therefore, I think that, in practice, we would find that this second criterion, "accounting and auditing related," would prove to be ambiguous. This remark leads to my major concern and one of the reasons that I am here.

I think if the accounting and auditing related criterion is adopted, it would lead to an erosion of many management advisory services that are presently conducted by CPAs for audit clients.

The rest of my comments relate mainly to the second criterion, although some of them do relate to the independence issue and to the origins of the practice of public accounting.

First of all, I would like to make a comment with respect to a sentence on page 3 of Public Notice 78-1. This sentence states that "the practice of public accounting has its origins in the attest function."

It is my belief that the practice of public accounting has its origins in bookkeeping and advisory services. To emphasize my belief, I have provided with my comments a copy of my article which appears in the Proceedings of the 1978 Southeast Regional Meeting of the American Accounting Association. In this article, which I will not read to you, you can see that advisory services can be traced to Eighteenth Century Scotland, which strongly indicates that our profession is really based on bookkeeping and advisory services. Tax and attest services are relative newcomers to our profession.

We have a rich tradition of providing business counsel and advice to our audit clients. I am amazed that the Executive Committee of the SEC

Practice Section and also the Public Oversight Board, without benefit of hard data, would embark on a course of eliminating this rich tradition of CPAs providing business counsel and services to their clients.

MR. GARRETT: Professor Mason, I suppose that I ought to interject as a matter of clarification. We haven't embarked on a damn thing except to develop views in response to a request from the Executive Committee that we advise them on their proposals.

PROFESSOR MASON: Okay.

MR. GARRETT: Otherwise, we wouldn't have come close to this problem. They laid this on us and said: "Now you tell us what you think of it," and we are trying to figure out what we think.

(Laughter)

PROFESSOR MASON: That's fine, but it depends on how one defines the word "embark."

MR. GARRETT: All right.

PROFESSOR MASON: A second point I would like to make, and this one deals with independence, is that hard data does not exist to support the notice that the area of services provided by public accounting firms to their audit clients results in a diminished independence or appearance of independence of the auditors. By hard data I mean specific instances where independence was compromised as a result of an MAS engagement.

What we have is soft information, that is, unsupported allegations, information that relies almost exclusively on opinions, predictions, estimates, and subjective evaluations.

We have seen over the last several years three or four studies conducted by Professor Titard, Professors Hartley and Ross, and others; and these studies imply that as a result of advisory services, the auditor identifies with the point of view of

management.

I just don't buy that. In fact, if we take a look at the Standards of Professional Conduct and Practice of the Association of Consulting Management Engineers (ACME), we see an emphasis on objectivity by the consultant. For example, Rule 1.1 of this Code states: "We will at all times place...or serve them /our clients/ with integrity, competence and independence. We will assume an independent position with the client, making certain that our advice to clients is based upon impartial consideration of all pertinent facts and responsible opinions."

Rule 2.7 states: "We will not serve a client under terms or conditions that might impair our objectivity, independence or integrity, and we will reserve the right to withdraw if conditions beyond our control develop to interfere with the successful conduct of the engagement."

Management consulting literature is replete with the need for consultants to be objective and independent; and yet, at the same time, we hear that because we are consultants, because we are providing management advice, we are not independent. Herein lies an obvious conflict, one involving what consultants profess to be an ethical code as opposed to unsupported opinions with regard to a CPA's supposed lack of independence when providing advisory services.

Further, I have reviewed the studies on MAS and auditor independence; and they seem to present a mixed bag of results. For example, if you take a look at the Titard study, you will note, for example, that one of the key areas where the respondents felt that advisory services would impair independence was business acquisitions and mergers. Yet if you look at the Hartley and Ross study, you will see that their results indicate that this is one of the areas

where respondents felt that independence would not likely be impaired.

In another area, plant layout and design, Titard found that his respondents foresaw little impact on auditor independence, whereas Hartley and Ross learned from their respondents that audit independence would be significantly impaired by such concomitant consulting advice. We have obvious conflicting results here.

Another aspect of audit independence we keep hearing about is the common stockholder, the common stockholder's confidence in the public accounting profession, and the common stockholder's view of the independence issue. I am not so certain that stockholders, the general stockholder, the Mom and Dad who happen to own 200 or 300 shares of AT & T, view auditor independence as an issue. In fact, when they look at the auditor's report, I sometimes think they look upon it as an insurance certificate. If something goes wrong with the corporation, they can sue the auditors and perhaps recover part of their loss. But to return to a point I made a few moments ago, at best such notions about the lack of independence are unsupported allegations. At worst, they are biased viewpoints, in my opinion, expressed by personnel agencies and non-CPA management consultants for the purpose of removing CPAs from management consulting and thus decreasing competition in such fields as executive recruitment, marketing analysis, and plant layout.

I doubt that this decreased competition would prove beneficial to audit clients, their creditors or shareholders. I think we are dealing here with an issue of who is goring whose ox. I think some of these individuals who represent or own personal agencies, or who represent or own management consulting

houses, think their ox is being gored because they don't have as close a relationship with clients as CPAs have with their audit clients; and I think they would like to have a bit of a turnabout so that the CPAs can't provide management advisory services for their audit clients. Limiting CPAs to auditing would give consulting houses and personnel agencies a clear advantage.

Another point I would like to make is that MAS capabilities within a CPA firm can enhance the audit function. We have already seen such enhancement with respect to information systems. As a result of providing clients with information systems skills and services, CPA firms have been better able to develop techniques for computer controls, computer controls evaluations, and computer auditing.

The same holds true, I believe, in the areas of marketing analysis, plant layout and other non-accounting fields of MAS or what some have alleged to be non-accounting fields of MAS.

For example, I believe that in the areas of plant layout and marketing analysis, the CPA's expertise, the in-house expertise possessed by CPA firms, can assist the firm in making audit decisions involving realization of assets.

Further, I point out that there is no evidence that the performance of these services has compromised any auditor. Quite the contrary, the performance of such services generally assists the CPA firm by providing its representatives with greater knowledge about the way its clients operate, the industries in which clients operate, and the quality of client personnel. In my opinion, such knowledge can only enhance the performance of the audit function.

Finally, two additional points: One, any

conclusion reached by this Board to recommend ending certain advisory services provided by CPA firms for their SEC audit clients will effectively curtail the performance of these services for non-SEC audit clients. Two, curtailment of advisory services by CPA firms may have a detrimental effect on accounting education.

Let me elaborate further. With respect to the former point, the ultimate impact, in my opinion, will be that many small and medium-sized business firms will be precluded from obtaining competent business counsel and advice. I say this because, given the legal environment in which CPA firms now operate, it would be extremely difficult for the profession to support two sets of standards, one set for SEC audit clients and a second set for non-SEC audit clients.

Thus, any action, and by action I mean recommendations made by this Board, could ultimately cutoff small and medium-sized businesses from management advisory services of CPAs, which could prove detrimental to these businesses; any, in my opinion, these detrimental effects would filter down to their creditors and shareholders. I say this because clients precluded from procuring services from their CPAs may do without such services altogether or, under certain circumstances, receive inferior services. This last possibility concerns me the most.

I work with a number of local CPA firms in Alabama and in West Virginia, and I have seen what I refer to as the "disco inferno" that is played for many small and medium-sized clients by hawkers of computer systems. I believe we are going to see more of this peddling of computer systems to small and medium-sized clients between now and 1985; and

if you cut these firms off from business counsel by their CPAs, you will see more disastrous computer acquisitions in the future than you have seen up to now.

Finally, as an accounting educator, I feel that curtailment of advisory services by CPA firms may have a detrimental effect on accounting education. Though accounting graduates enter into public accounting, business service and government service, many departments or schools of accounting gear their curricula to the public accounting career track. If these departments or schools of accounting perceive that public accounting consists only of auditing-related services, they might effectively remove the field of business from accounting education. Such a move would set accounting education back 20 years, to a time when most of our courses dealt with how to record debits and credits for retail stores, for manufacturing firms, and for hotels.

In the last ten to fifteen years we have been able to include a considerable amount of business education in accounting. If we effectively remove management advisory services from the field, or if we give a signal to the universities and colleges that we are proscribing or limiting advisory services that can be performed by CPA firms for their audit clients, we will also signal them to begin removing non-accounting business courses from the accounting curriculum.

As one who maintains that a good auditor must have a keen understanding of business and how it operates, I am gravely concerned that any action by this Board or the Executive Committee to curtail significant advisory services will, in the long run, adversely affect accounting education.

I am not a Pollyanna. I do foresee problems. One of the problems I foresee is competence--one of the cornerstones of this profession. There is the collective aspect of competence by CPAs. Competence insures public confidence in all of the services that CPAs provide. I recommend, therefore, that instead of looking at the appearance of independence issue, that this Board look at the competence issue, and that certain standards of competence should be designed before a CPA firm, whether local, regional, or national, be able to offer services in a given area.

I think competence is the key, but how do CPA firms become competent to offer advisory services? Do they accomplish this through hiring of personnel, formal education, examination? As far as I know, there are no examinations required for CPAs before they can offer certain types of advisory services.

Another means of acquiring competence is experience, and still another is continuing professional education.

To insure competence in management advisory services and thus maintain the public's confidence in all services that CPAs provide, I recommend that clear standards be established for competence before CPA firms can offer management advisory services.

In conclusion, I recommend that this Board not act without regard to hard evidence, and that in the absence of hard evidence the Board not recommend the curtailment of services which are beneficial both to business firms and their auditors. Further, I hope that this Board keeps in mind the impact that its recommendations could have on accounting education.

Again, in terms of recommendations, get some hard data. Since SEC Practice Section firms are going to have to submit to peer review, one might,

to insure both independence and competence, extend beyond auditing services to management advisory services engagements and then try to draw conclusions about whether or not such MAS engagements compromise the audit process.

Moreover, conduct extensive interviews. If we are going to rely on soft information, I would much rather see the Board rely on extensive interviews rather than the more impersonal questionnaires. The questionnaire technique presents, more or less, a binary choice situation; for example, does the respondent feel that such a service might impair independence or might not? From the questionnaire we have no idea as to how hard and fast the respondent's convictions are.

Secondly, the questionnaire doesn't tell us very much about cause and effect. Even in situations where respondents reported no confidence in CPAs, eliminating management advisory services does not mean that we would upgrade their responses from "no" to "perhaps" or "maybe?" We don't know from the questionnaire technique why the respondents voted "no confidence." For this reason, I recommend that research be conducted through in-depth interviews rather than by questionnaire.

Those are my comments.

MR. GARRETT: Thank you, Professor Mason. I am sure you still teach the basics that debits are toward the door and credits are toward the window.

PROFESSOR MASON: I basically teach in the auditing area, systems area, and operations area. Therefore, I really don't become involved with debits and credits to any great extent, although I appreciate their importance.

MR. MANZONI: I just have one. One of the

commentators--it wasn't today--it was in the written comments--talked not so much about having a competitive edge on the inside track, but talked about auditors having access to trade secrets through auditing information and such. I think the comments were from an EDP group.

Is there any merit to that sort of argument? Are there trade secrets that an auditing firm can obtain by doing an audit of an information system?

PROFESSOR MASON: I don't think you would learn any trade secrets. I think you could build an extensive data bank of experience relative to information systems, and I think that would be extremely helpful.

MR. MANZONI: So that auditors in effect then, they do have a better chance of gathering information through a means which other EDP people don't have an opportunity.

PROFESSOR MASON: CPA firms have an opportunity to develop hands-on EDP expertise and maintain a data bank on this expertise. Should they run into a problem, and the chances are that someone in their organizations has probably run into a similar problem elsewhere. They could contact that individual for assistance. There are certain economies, you know, that are brought about by size of firm and diversity of client base.

MR. MANZONI: This is not largeness. This is having an opportunity to go in and audit everyone else's system.

PROFESSOR MASON: That is acquired through being a large auditing firm, I would think.

MR. MANZONI: A data processing company that was very large but it wasn't an auditor wouldn't have the same opportunity.

PROFESSOR MASON: Well, an auditing firm

probably has devoted a great deal of time to considering controls that ought to be there; and therefore, that should give a firm a significant edge, I would think.

I would think that many of those in EDP who do not have an accounting background do not place the same emphasis on controls as do CPAs.

MR. GARRETT: Mr. Mason, at this hour of the evening the idea of embarking on a program of research through interviews is not terribly enticing. (Laughter) But maybe it will be in the morning.

The idea of a lack of hard data and clear evidence keeps coming up, and I keep coming back with the same question.

How would you ever get it, and we have never got it with respect--

PROFESSOR MASON: --I think--

MR. GARRETT: Let me finish the thought because I think they are somewhat parallel. We have never gotten it and don't even ask for it with respect to independence based upon financial interest, and it is well established in the profession and in the regulatory views also that if you own stock in the client, your independence is impaired, and nobody says that to establish that we have to show that you deliberately or because of that did not audit carefully or participated in something that was improper in the way of financial reporting. But when it comes to MAS and independence, everybody seems to want to say that we have got to find a smoking gun before there is a case.

I suppose somewhere there might exist a tape some day in which some idiot says: "I am going to blow this audit because I can sell them my actuarial service if I cooperate," but I don't really expect ever to find that. If any principles in this area have to be based upon that kind of data, then of course, it is an argument leading you to do nothing because you will never build that kind of case.

Interviews conceivably, we might. I quite agree with you on the questionnaires. All of us were laughing at this Streichman questionnaire that Haskins & Sells sponsored and passed around. That was with respect to whether MAS can impair auditors' independence, the lawyers as a category--and they have several categories if you have seen it--came up with the highest score adverse to independence. That is because the question was: Do you think that the providing of MAS might impair independence? Any lawyer is going to answer that yes. I mean, there is only one possible answer to that. Of course, it might, and I agree with you, but I do think in criticizing the Section on its addressing the problem, we have to accept the fact that the kind of hard data that you think you want is just not going to be attainable one way or the other.

PROFESSOR MASON: But I am also reminded of the numerous court cases that came about during the Sixties and Seventies where everyone from lawyer to SEC to CFAs to financial executives, conducted an autopsy of every corporation that turned belly up, and they came with many reasons like: "The auditor was too close to management;" but I have yet to see a case at this close scrutiny where one even suggested, except perhaps for Professor Briloff,--

Mr. GARRETT: You may be right about that.

PROFESSOR MASON: --that the CPA did not report fairly or did not conduct an adequate examination and prepare a proper report because of an MAS engagement conflict. It would seem to me that every possible allegation of compromise of independence was suggested during these autopsies of those cases that went to court. I have not examined, and therefore I don't know, whether the auditors for those clients conducted

MAS engagements; but no one was able to come up with any relationship between an MAS engagement and the alleged poor quality of the audit.

MR. GARRETT: That is an interesting observation. I had not heard that before.

MR. McCLOY: I join you, Mr. Garrett; I don't place a great deal of importance on the fact that we haven't had a nice all fours case here. I think there are cases that one could find where too close an association did tend to prejudice the objectivity of the report. I wouldn't want to quote particular instances from my experiences, but I do think it is a concern. I am not comforted by the fact that so many people have testified that after years of years of investigation of this and not a single case came up. I don't think that means that there weren't cases where the association distorted the result.

PROFESSOR MASON: Perhaps it is a type of negative assurance!

MR. McCLOY: I don't think I have got anything more.

MR. GARRETT: Thank you very much for coming and giving us the benefit of your views. It was very interesting.

PROFESSOR MASON: Thank you for permitting me to appear.

MR. GARRETT: We meet again at 8:30. That is what Lou Matusiak's schedule says.

(The hearing recessed at 6:00 o'clock.)

FRIDAY MORNING SESSION

August 18, 1978

The hearing convened at 8:30 o'clock with Mr. Garrett presiding.

MR. GARRETT: Ladies and gentlemen, let's come to order for the morning.

For those of you who were not here yesterday, there are a couple of bits of information I could add. This is a hearing for the purpose of educating the Board. We are grateful to all of you that are willing to share your views with us.

Our immediate remedial purpose is to respond to the request of the Executive Committee of the SEC Practice Section who have issued proposed rules in the area of scope of services--rules for the SEC Practice Section and have requested our views on these proposals before taking any further action.

This Board itself does not take official action in the sense of adopting rules or repealing them. Our role is advisory. Nevertheless, in the posture in which this particular problem finds itself, we expect our views will have some influence.

On administrative matters, with respect to the transcript, it will be a publicly available document. Those persons that are making presentations will be given an opportunity to correct the transcript before it is put in shape for any broader distribution, and anybody wishing to get on the list to obtain a copy should get in touch with Lou Matusiak either during today or write or telephone him when you get back to your offices.

Copies of the submissions that have been made in writing are also available. These can be examined at Lou's office in New York City where copies are available upon request for a nominal charge determined by Lou to approximate the cost of reproduction.

With that, is Mr. Moss here? Henry Moss of
Altschuler, Melvoin and Glasser is our first witness.

Good morning, Mr. Moss.

MR. HENRY S. MOSS: Good morning, Mr. Garrett.

MR. GARRETT: Indeed I should also explain we have allotted a half hour to each witness. Whatever you do not spend in your prepared remarks, I suspect will be taken up with questions, but you are free to proceed in any way that you wish.

MR. MOSS: Thank you.

Gentlemen:

Thank you for affording to me the opportunity to discuss possible limitations of MAS as they may apply to the scope of practice within our profession. I wish to point out that I am not directly concerned about these limitations as they may impact upon "national firms" and their publicly held (i.e., SEC clients). Those firms, I am sure, have provided to you their insights, experiences, and thoughts regarding the future, far more thoroughly and with greater relevancy that I could hope to achieve. However, I am deeply concerned that judgments which you, the Public Oversight Board, render with respect to constraints upon service scope for SEC clients will inevitably impact (and impact adversely) upon the very large segment of the U.S. economy--the small business enterprise, which I might say are the type of clients that we in our firm handle.

I speak to you this afternoon as a CPA whose area of professional practice is limited to providing management advisory services therefore not as either a partner of Altschuler, Melvoin and Glasser although my partners are in agreement with these remarks or as a representative of any group of CPAs or CPA firms. I don't speak to you as a representative of any group of CPAs or CPA firms, although I have reviewed my remarks with fellow members of the MAS Small Business Subcommittee and I can report to you that they are in full agreement with these remarks. To help you view my remarks in context, the following describes some of my major exposures within our profession.

I am presently, and have been for the past ten years, the partner in charge of management advisory services for Altschuler, Melvoin and Glasser. We are a single office firm located in Chicago. I might add parenthetically that we have had at least one full-time MAS practitioner for more than thirty years.

I am a member of the Illinois CPA Society, and former Chairman of its MAS Committee.

I am a member of the American Institute of CPAs and a former member of both the MAS Executive Committee and the Technical Standards Subcommittee.

I am presently Chairman of the AICPA MAS Subcommittee on Small Business Consulting, Codirector of the National MAS Training Program and Chairman of its Steering Committee.

I speak to you from this background of experience gained over time and through such exposures to a relatively broad spectrum of our profession and its members.

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First, let us address "Will limitations placed upon SEC practitioners impact upon smaller CPA firms providing services to privately held clients?"

In my judgment, any artificial limitation imposed upon the segment of the profession consisting of approximately 500 practice units must, of necessity, filter through to all of the other 20,000 practice units.

We all hold ourselves out as Certified Public Accountants and most of us (as members of the AICPA) do, in fact, represent to our clients that we meet its high practice standards and do observe very rigid ethical practice and restraints. Therefore, to legislate that one class of CPA's may perform certain services and that a different class may not is to deny both the rules and realities of our profession. This is not to say that we all practice with similar client bases, or provide a homogenous mix of services. Some practitioners provide solely tax assistance, others solely financial advisory services, others maintain books and records for

their clients and others a broad mix of audit, accounting and other related services. But it is the personality, and skills of the practitioner, and the demands of the clients of the firm that shape scope, not an imposed rule. Thus, when any CPA, regardless of the size of his firm or his clientele, performs a service, that specific service is provided to the best of his ability in accordance with standards established for the entire profession. Indeed, it would be difficult, if not impossible, to provide two sets of standards which a practitioner must follow, which depend not upon the nature of the service or the client, but solely upon some other aspect, such as how broadly the client's stock may be held.

Therefore, I conclude a limitation upon a few of us will, in fact, become (soon) a limitation upon all of us. The only alternative to this approach of consistency will, in my judgment, be the fracturing of the AICPA into two complete entities, i.e., those practitioners who choose to provide services to publicly held clients in the one, and those practitioners who provide services to privately held entities in the other. Such a schism would inevitably both reduce the competitive choices available to business entities and impair the quality of services provided to each client segment.

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I will now address the impact, of MAS scope limitations, on our clients.

Our clients are typically part of that large segment of business, the privately owned, closely held, owner-managed enterprises, which usually do not have in its organization any depth of professional business skills.

According to statements I have recently seen, 96% of all of the U.S. business entities, some 9,000,000 units, have these characteristics.

A privately held company, of the type with which I am most familiar, will typically select as his independent accountant the firm or practitioner that he feels will be most responsive to his total perceived needs. Thus, in terms of the fees he pays, the audit may represent the largest segment by far, but in terms of his satisfaction with his CPA, the audit may often rank far behind the general and specific advice he solicits and receives in business management and tax matters. He wants a trained practitioner to provide guidance in such matters as tax planning, product cost, plant expansion, sales commission plans, acquisition and utilization of a computer and, specific assistance in such matters as cost accounting systems, computer programming and in recruiting controllers, bookkeepers, data processing personnel and the like. Let us look at the impact upon the client if some of the talked about restraints were placed upon us. Typically, the advice type of questions, which now are handled over the phone or at lunch, are not now discussed by the client with anyone other than his CPA. If he were to utilize some other consultant, it would be at significant cost, because he (the consultant) did not have the continuity of understanding of that particular business that is inherent in the CPA's relationship with his client. Let us look for a moment at a specific service area, the question of executive recruiting from the client's point of view.

If the client has need for staffing assistance in his accounting function, he normally comes first to his CPA. He can do this confidentially without unduly alarming the existing personnel. He will be presented with several candidates whom the CPA considers to be technically qualified for his final selection. If the client were to receive a comparable service at comparable cost through other qualified sources, he would still in most instances request his CPA to help define the

position, to interview the prospective candidate, and evaluate his technical qualifications. This redundancy of work effort would, of course, increase the total cost to the client.

So thus we have a situation whereby if recruiting services were prohibited, the client's needs might be met only at increased cost, and with no assurance of a better quality of service.

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Finally, I would like to consider the impact of scope limitations upon the very important and needed "attest" function of our practice. We are a large single office firm, and yet we are not large enough to maintain on our audit staff, full-time capability in such quantitative areas as electronic data processing, statistical sampling, and the current techniques of resolving discounted cash flow and present value problems. Our MAS staff are continually striving to upgrade their skills in these functions. Thus, the cross-pollination for continuing improvement of our audit skills is enhanced by the MAS function. Scope limitations which might cause us to reduce our MAS staff, and thus lessen our ability to attract and retain qualified specialists because of lessened opportunities for advancement in a smaller environment must therefore, of necessity, ultimately impact adversely upon the quality of our remaining MAS practitioners. This, in turn, would reduce their ability to support the auditor, and thus the future quality of our audit service may be diminished.

I have not addressed myself to the elusive specter of potential impairment of independence through MAS activities because I understand others have done so. However, I do wish the record to show that in my judgment our clients consider themselves well served if, as they request, we provide service with integrity and objectivity. That is what they are paying for

and that is what we strive to provide. If as the current Institute pronouncements indicate that such qualities truly define independence vis-a-vis MAS, then the question of theoretical impairment is moot.

If the definition of independence for MAS is to include all possible aspects of appearance in addition to integrity and objectivity, then it should only be so changed if there is a demonstrated need based upon factual presentation. I am not aware of any such presentation. But I am well aware that our clients have needs for these services and continue to request that we provide them.

I will be pleased to respond to any questions you may have. Again, let me thank you and wish you well in your deliberations.

MR. GARRETT: Gentlemen.

MR. McCLOY: You say you have a rule in your executive recruitment that you proffer three or four candidates rather than one?

MR. MOSS: Multiple, sir, and always two, hopefully more.

MR. McCLOY: Why is that?

MR. MOSS: Because we never want to be in a position of providing only one alternative to the clients. The client must make final decision.

MR. McCLOY: If you did provide one alternative, would that impair, in your judgment, the independence concept?

MR. MOSS: I think it would relate closely to it, sir, yes. If we present a recommendation to a client of any type whether it be executive recruiting or selection of a computer and say there is no other alternative, we are, in effect, putting ourselves in the role of management, and we try very hard to shy away from that.

MR. McCLOY: Can I ask how large a part of your business is executive recruitment very roughly?

MR. MOSS: We have an eight-person MAS Staff. We probably spend less than one full-time person, or the equivalent of that. In essence, in terms of dollar revenue to us, it is a very small portion. In terms of the contacts at the top level of a client, it becomes a very significant portion.

MR. McCLOY: You are constantly being, I suppose, telephoned or called up and they would say, "Do you know a good man here or there?"

MR. MOSS: That automatically, but for example, it just so happened yesterday one of our clients who happens to be based in Milwaukee was on the phone three or four times with me yesterday, arranged for a data processing manager candidate from the Minneapolis area to come down to our offices yesterday afternoon. One of our managers and myself spent two hours with

him, and then I brought that candidate out to the client's house in the northern suburbs yesterday evening.

That is not unusual that our clients want that type of close contact.

MR. McCLOY: Do you always charge for that service?

MR. MOSS: We always charge for our time, sir, so that it makes no difference how we spend our time. If we are spending it productively for the client, then we charge for it.

MR. McCLOY: Outside of your tax service, what is the other main MAS that you engage in?

MR. MOSS: The vast bulk of our services are related to a computer in one form or another. We will make computer feasibility studies.

I got another phone yesterday authorizing us to make an operational audit of the efficiency of one of our larger client's data processing department.

We, in some cases, will assist clients in actually programming their computer.

MR. McCLOY: Do you do any actuarial work?

MR. MOSS: No, sir.

MR. McCLOY: That is all.

MR. GARRETT: Bill, do you have any questions?

PROFESSOR CARY: May I ask Mr. Moss, taking the average client--that is rather difficult to pick the average client--but on the average, what would you say the revenue for you in respect to the attest function versus the other functions that you perform is? What is the relationship?

MR. MOSS: I don't know if I can quite state it in terms of the average client, but in terms of the total firm revenues, it is approximately 85% audit, 10% tax and 5 % MAS. I may be a few percentage points off.

PROFESSOR CARY: And the balance is MAS.

MR. MOSS: And the balance is MAS.

PROFESSOR CARY: So that in a sense the notion that if we throw tax into audit because at least some of us have this notion that tax is an absolute essential role of accounting firms, historically, and therefore probably today, if we throw that out, there will be very little evidence that the amount you do in respect to MAS would interfere with the independence that you would exercise in respect of audit. Isn't that correct?

MR. MOSS: I would certainly concur.

PROFESSOR CARY: You would concur. That is where you come out?

MR. MOSS: Right. Our posture regarding MAS is not that it is a money maker for my partners and myself. Our posture is that it is a service necessary to support the client relationships, to give the client help in those areas which he requests, and we feel it is very good both from a business attraction and a business retention standpoint even though it does not materially affect our revenues.

PROFESSOR CARY: You don't have many cases in which the MAS side of it is more than, say, 25% of the total fees from the audit firm?

MR. MOSS: In some instances, some very few instances, this may happen if we are assisting a client in, let's say, a rather large computer installation.

PROFESSOR CARY: One shot.

MR. MOSS: Then in the one or two years that that takes we may get larger fees than the audit, but over the life cycle of a client relationship, the MAS fees tend to be very small compared to the total audit fees.

PROFESSOR CARY: Thank you.

MR. MATUSIAK: A question of clarification. This is an 85-10-5% breakdown. Does the 5% include only formal MAS engagements that are subject to separate billing, or does that also include the day-to-day consulting on operational matters?

MR. MOSS: I think your clarification is a good point. I am breaking our fees down in terms of the people who are in each of the departments.

There is no question that my audit partners do frequently, either without me or with me, will spend time in conference with the clients discussing their broad business matters.

MR. MATUSIAK: That is accounted for as auditing fees?

MR. MOSS: We don't segregate. That is why I can't give you an exact breakdown, but it would be listed in our time sheets as conference time. Most of the conference time would be what we are calling advisory services here, so from that standpoint probably our advisory function is more like 10% than 5% of our total revenues.

MR. McCLOY: On your recruiting business, may I intervene again, sir, if you were making a recommendation, say, for an accounting officer to the client, do you ever recommend an accountant from competitor of yours?

MR. MOSS: I would say the vast majority of the people whom we recommend who have had public accounting experience are non-AM & G alumni. The AM & G alumni that we help place probably amount to less than one person a year.

What happens is that most of our alumni who are very competent go into smaller CPA firms. They tend not to go into public practice on their own.

MR. GARRETT: Mr. Moss, we have heard from you and from others including Professor Mason yesterday afternoon on the stimulating effects, so to speak, of the MAS aspect of the public accounting practice both in attracting students into the profession and also attracting graduates of schools into particular firms. But one thing we have neglected to ask, and I certainly don't know, is the extent to which these MAS services are performed by CPAs.

I wonder how stimulating it would be to have an actuarial capability if it was all done by actuaries who weren't CPAs and sat off in a different office and were not part of the normal career development.

How does it work with your firm? Is your MAS staff all or predominantly CPAs?

MR. MOSS: I am sorry to say no. Right now of the eight of us, I am the only CPA. I might mention I am trained primarily as an industrial engineer, and when I got into this profession, I felt it important to become a CPA, but I can also say to you that of the eight, six are in school in the evenings, and if you were to hold these hearings a year from now, I hope I could make a much more positive statement.

In our firm we do put, if not pressure, we certainly hold out an enticement or carrot saying: We want you very much to become a CPA and be a full part of the profession.

MR. GARRETT: But the MAS experience, I gather from your response, is not part of the normal career path development for someone looking toward leadership in a CPA firm?

MR. MOSS: No, in a firm such as ours, typically the senior partners and typically the fastest track to partnership is through the audit function.

We have been unable in our firm to attract men and women for MAS, from the audit staff, because they see that if they were to do that, they would perhaps be coming in at the bottom end of a department while they already have progressed quite well within the audit functions.

MR. GARRETT: One other question. Have you had a chance to examine the Executive Committee's proposals that are the specific subject of this hearing and measure your own MAS services against them?

MR. MOSS: Yes sir.

MR. GARRETT: And do you think it would affect

what you are now doing if they were to become Section rules?

Don't give away the store if there is something you are going to want to argue about, but some ideas.

MR. MOSS: If you are asking me: What do I feel vis-a-vis our own firm's practice, I can answer fairly specifically.

As I mentioned before, I am trained as an industrial engineer, but we long ago decided that we were not going to do industrial engineering work or plant layout, time study or whatever it may be because it didn't fit into our perceived areas of the services we wanted to render, not that we felt that it was inherently wrong, but we as a firm just chose not to enter into that.

The same thing for the marketing and the actuarial services, perhaps because we never had a large enough demand.

I know of no way that we can stay in business as CPAs and not provide assistance in recruiting bookkeepers, accountants, controllers, because we get the phone call that you mentioned earlier: "Do you know somebody who can help us in this area?" or "I am thinking of hiring this person as my controller. Will you talk with him. Will you check out their references?" Whatever it is.

These calls have been in existence since we as a firm have been in existence. We just don't know how to get out of that business and still meet the very needs of our clients.

MR. GARRETT: But your other businesses, your other services, would seem to come within the standards set out in these proposals, auditing-and accounting-related skills?

MR. MOSS: I certainly consider anything having to do with a computer today related to accounting and auditing. I don't know how to distinguish between them even though some applications we work on in the computer area, for instance, sales history or inventory management are not specifically related to the books of account, but they flow from or to the books of account.

MR. GARRETT: Anything else?

PROFESSOR CARY: I would just like to follow through. Certainly one of the basic reasons why there is a rationale for MAS in an accounting firm as another function is a point I think you have brought out, namely that it helps in the auditing today. I mean it is almost a necessary ingredient I take it.

Doubts were raised in my mind when you say you are the only CPA, and therefore, the rest are not.

How do you tie in the MAS role, computer understanding and so forth with the audit function in your firm?

MR. MOSS: We perform no MAS services without reviewing the project in advance with the audit partner and manager. We make no recommendations to the client without reviewing those recommendations with the audit partner and manager, and generally, half way through, let's say we are designing an accounting system, a fairly standard sort of thing, then we will review the design and concept with our audit people to make sure that the controls and checks and balances are there.

Also, as I indicated in my prepared remarks, we provide assistance to the audit staff in such matters as internal control systems, EDP audit techniques, statistical sampling and present value analysis.

I might also say that our people by and large on our MAS staff are either trained as or are training themselves through formal education as accountants, and they speak and lunch with and are a part of our in-house training programs. They just have not passed the exam, but they hopefully will do so fairly soon.

MR. MANZONI: You mentioned that there is heavy emphasis in your firm on computers.

Do you do what has been referred to as turn key arrangements?

MR. MOSS: We will not use that word because a turn-key to us implies that the client waves a magic wand and everything is ready.

We will do nothing unless the client participates very actively, but we will provide services in a broad spectrum from systems design, program specs, programming, testing and training of the people, but we expect the client, and will not touch a job to have an executive working with our project team every step of the way and will not touch such a job without such an assurance.

MR. MANZONI: You mentioned that in one of the cases you were involved in you actually did some programming.

MR. MOSS: Yes sir.

MR. MANZONI: To what extent would the client have been involved in that process?

MR. MOSS: The client will review the program specifications, will review the test results.

MR. GARRETT: Thank you very much, Mr. Moss.

MR. MOSS: Thank you, sir. Thank you, gentlemen.

MR. GARRETT: Mr. Klion, Peat, Marwick, Mitchell & Company.

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MR. STANLEY R. KLION: Good morning, gentlemen. I am Stanley Klion, Vice Chairman of Management Consulting of Peat, Marwick & Mitchell Company. I am Chairman of the AICPA MAS Executive Committee.

By way of background, I have been with my firm since 1955, always in the MAS department, and like Henry Moss who preceded me on the stand, I am also an industrial engineer and a CPA.

During all of my career, I have participated actively in Institute and State Society affairs, and I guess I have participated in a good deal of the professional writing that has been referenced in all of the documents that come before your Board, including, I might add, SAS-11 to which reference has been made frequently.

Rather than read my testimony, which I submitted to Mr. Matusiak several weeks ago, I would like to highlight, if I may, a few points which I think are particularly relevant and then engage in such dialogue as the Board might require.

I am very grateful for the opportunity to come here as is my firm because I believe the judgments that derive out of this Board will be particularly significant to our profession.

Mr. Garrett observed early on this morning that you do not stand the test of law, but sir, I would suggest to you that your opinions may have more than just a little bit of weight, and you will not only affect our scope of practice, I think indeed, you will affect the vitality and the viability of our practice and everybody will be so affected, practitioner, many of whom will be before you, the clients whom we serve, the Federal government and society at large. I do not believe those are separable; I think they all relate one to the other.

I am sure that many of my predecessors to

this table have some and spoken about the single criterion which so many of us believe is the only yardstick against which we should measure the practice that we do, namely, independence. Independence, of course, depends upon role and that is a word I am sure you have your fill of, but let me speak for just a minute about what most of us believe role to be. It means careful control of not participating in management decisions. That is not something that is unique to the CPA profession. That is indiginous to quality consulting.

It is interesting that the role of the CPA firms, of which I know, which have standard manuals and most of the non-CPA management consulting firms, of which I know, including the major ones whose names are familiar, all stipulate quite clearly that they will not engage in management decision making, and they measure their performance against that rule.

The effort to define scope of practice in terms of functions or the technical content of work that is being done, has simply failed to be effective. To put it another way, I can be just as contaminated in terms of independence by doing accounting-and auditing-related work as doing non-auditing-and accounting-related work. It simply depends on whether or not I am a participant in management or I am a counselor to management.

I would agree that that is not an easy line to draw. That is the skill of the consultant. It is in the client's self-interest to see that the consultant maintains that role, and the adherence to that role is absolutely crucial to an understanding, it seems to me, of the definition of scope and the constraints that may be placed upon it.

To repeat, I can be just as guilty or just as pure by doing accounting-and auditing-related work as nonaccounting and nonauditing-related work.

That is not the criterion against which my

independence should be measured because it isn't relevant to my independence.

Mr. Cary commented to the previous witness as to the support that the auditor gets, indeed, must get from MAS services. I am sure many have said to you before that the existence of MAS activities becomes increasingly more attractive to the young people whom we attract to this profession and on whom all professions depend wholly.

I think there is a clear correlation between the quality of person that enters the accounting profession now, who is discarding the old green eye shade stereotype, if you will, that many of us have considered as accountants heretofore, and the diversity of activities which the accounting profession renders to its clients.

We are charged by the public and by the government, to know the businesses we audit, to know the business, not just deal with "the figures," and that requirement to know depends upon a broad array of professional skills.

Chairman Williams of the SEC has said quite clearly that we are going to have to report on the internal controls of our clients. Current value accounting is here upon us. Prospective reporting is something that all of us are asked to speak to.

Our responsibilities to the public increase, and in my view, properly so. It is ironic, indeed, that the GAO, the Congress' own accounting arm, has more than half of its people in non-audit activities, in what we would call MAS skills, because the GAO perceives the need for such talent, and the very same Congress, through some of its representatives, is trying to say to us that we should go the other way, that we should narrow the skills that we have.

It simply doesn't stand the test of logic.

I would argue, as so many have argued before, that the presence of MAS assists in making better audits, and the converse of that is equally true--the absence of MAS will make poorer audits.

Finally, let me observe that as again I am sure many have, that there is simply no evidence that has ever been presented to suggest that the practice of MAS clouds our independence. In my briefings last evening and this morning, I have been told that the Board considers the absence of a "smoking gun" not particularly relevant. I might share in that view in some measure. But there is hardly a subject that has gotten more research than the potential compromise of independence of MAS services. It has been the subject, I suppose, of more doctoral theses of schools of accounting than almost any other you might think of, and if a "smoking gun" were there, the Lord knows somebody would have found it by now because an awful lot of people have looked for it. The fact is that it just doesn't exist. It just doesn't exist.

We would argue my firm--I personally, and a great many of my colleagues--that society becomes the poorer from the service of accountancy if we are not permitted to render competent services which are generally described as MAS. I should say, of course, that competence and due care is a presumption. If you do not have that, then all of the other arguments go aside. Then you simply shouldn't practice your profession.

Now may I serve the Board in any other way.

MR. GARRETT: Gentlemen:

MR. McCLOY: I think I am one of those that have probably been quoted as being a little bit skeptical about this talk about no case ever having come, no smoking gun having ever been found.

I think I know out of my own experiences,

of cases where there has been too close an association between the accountant and the management which has not been conducive to good results.

There does seem to be a substantial amount of opinions, that have been quoted, I guess, a significant minority who felt that this area did in some way compromise independence.

It is a little difficult to analyze and to put your finger on it.

Let me start out by asking you, out of your great experience, what, if anything, should we be doing that we are not doing now to help insure the objectivity and the independence of the accountants? Is there any area that you feel would really be relevant that we might look into to enhance the probability of objectivity that we are not doing now?

MR. KLION: Yes, sir. I would like to answer perhaps one comment you made as well as your question.

I don't doubt for a minute that there are cases where accountants and management have been perceived to be too close together and indeed even having actually having been too close together. I submit that problem is not a function of the particular activities they were practicing, but rather a function of the relationship of two people. One can compromise one's independence just as easily doing audits as doing MAS work.

MR. McCLOY: I am interested in what you say about that.

MR. KLION: I think there is one enormously important thing that this Board could do, and that is to bring this discussion to the beginning of its end.

I think accountants have labored under a

cloud relative to MAS activities for virtually as long as I have been practicing, and that is 23 years.

In the late Sixties we went through a burst of time not unlike this. As my testimony suggests, the late Manuel Cohen made observation about some of the concerns that he had, and I would observe with some comfort that his Commission, which he chaired so brilliantly before he passed away, came to the conclusion that no restriction was necessary. We have invested enormous time and enormous costs and more importantly credibility, I think, with the public, and we seem to be dealing solely with perceptions or possibilities. As to the "significant minority" sir, to which you refer, I think the same source comments that the more familiar or the more sophisticated the observer is with the (MAS) service, the less concern he or she has.

I think it is time to bring the subject to an end, and I think the opinion of this Board will be enormously important in so doing.

I made the case in my testimony that, recognizing very clearly that my Chairman also serves as Chairman of the SEC Practice Section, I believe the amendments which are really the principal subject of this hearing are excessively restrictive. I do not think they stand the test of logic, and my testimony, with his very clear approval, says that.

We are quite prepared to live with that testimony in spirit and in letter, and indeed, we have adjusted our scope at the moment to accommodate everything that is there. That doesn't represent very much of an adjustment for us, but whatever was necessary, we have done.

We have done so in the hope that this will be the end of this cloud, that we will be permitted to practice our profession soundly and competently

and under the constraints that we impose upon ourselves.

I know of no profession that has put stronger constraints on its behavior than the accounting profession has. So, despite the fact that we believe this amendment is excessive, we believe it is important to get this matter behind us, and Mr. McCloy, if this Board does nothing more than assist in that activity, I think it will help the accounting profession to re-establish its credibility beyond anything else.

That is sort of a long-winded answer to your question.

MR. McCLOY: That is quite a responsibility you put on this Board. We are new boys in this thing. After all, as you say, there have been 20 years of discussion. We have only been seized with this question for the last couple of weeks.

I understand your point on that, but I was reaching out, I think, for something else. I can understand that is a negative position. We put this thing to bed. That is fine.

Is there anything affirmative in addition to that which we could do that would tend to insure or help insure, enhance the atmosphere of independence?

You can't legislate independence. You can't legislate that. I am perfectly clear on that.

MR. KLION: Legislating morality, and that isn't a doable thing.

Mr. McCLOY: You can't do it, but there are things that can be done.

A number of people testified yesterday about pointing out a number of features that were conducive to the concept of independence.

I just wondered whether out of your experience you think there is anything that we should stress on the positive side.

MR. KLION: I think the existence of the Board is a positive manifestation of the things that have been done. The profession has, in fact, put its stewardship under the surveillance of a distinguished panel of five non-accountants. You have dealt with questions of peer review. You have dealt with questions of sanctions against misbehavior, and I think all of those things are fine.

I might add that while peer review at the moment relates only to audit activities, my own firm, and most of the large firms of which I know, provide internal quality assurance procedures involving all three departments under the same type of review.

I have in my bag now the results of our own internal quality assurance program which is an around-the-clock, constant thing. Indeed, one of the persons present in this room now who is one of my partners, is a member of what we call Professional Practice Review Committee.

It is a major job of reviewing our own performance, and I think the establishment of this Board is a way of doing that for the profession as a whole. This quality assurance is indeed a very positive step in that regard.

MR. McCLOY: Does your firm do executive recruiting?

MR. KLION: Yes, sir, we do.

MR. McCLOY: Do you have this rule that you never make a proposal unless it is multiplied?

MR. KLION: Yes, sir, and for the reasons that Henry Moss spoke because if you offer only one person, you are making a management decision de facto if not de jure.

MR. McCLOY: But if you did offer only one man, do you think that would impair the objectivity or the independence of your position?

MR. KLION: I don't think it would impair it in fact, but it might impair it in appearance, and that is one of the reasons why we don't do it.

I might add, sir, that providing executive recruiting services as those of us who do, under formal, rigorous professional constraints, in my view, is a great deal sounder than having the permission or the ability "to refer some one known to us," to quote the amendment.

If ever there is an opportunity for the appearance of a lack of independence, it is clearly that. Which is preferable--"I have a friend, and wouldn't you like to hire him?" or "would you like to pay me for the service of really researching whether these candidates meet your needs?"

I don't have a great deal of problem in deciding which one appears to be better.

MR. McCLOY: The one is more professional.

MR. KLION: Absolutely.

MR. GARRETT: Mr. Klion, after that, what is your attitude or your views toward the Executive Committee proposals?

MR. KLION: Well, sir, as I tried to set forth, Mr. Garrett, I believe the amendment that is the subject of this hearing is based on incorrect criteria, because it is trying to define independence in terms of function or technical content.

MR. GARRETT: You would drop the accounting, auditing skill?

MR. KLION: That criterion, I do not believe, is relevant.

Let me say quite clearly that the impact of that amendment as it presently stands is deminimus to my firm. It costs us some modest amount of business and we are quite prepared to dismiss it.

What is wrong about it, in my view, is the

fact that it is fallacious in its reasoning and it is susceptible to expansion on equally fallacious grounds.

MR. GARRETT: Do you see no room for a compatibility concept or even a dignitary concept, if you wish?

MR. KLION: Yes, sir, I think compatibility is a perfectly rational thing. I think dignity, which is another way of saying the same thing, is fine. I just don't believe that proscribing what I do is a function of my independence. It is a question of my relationship with my client.

MR. GARRETT: That may be true. I don't know that the Section's rules have to hang on scope rules on independence. You have urged that that be the only thing.

MR. KLION: As I understand it, the limitations that the amendment seeks to place on scope is to establish beyond doubt the independence of the accountant and the totality of his relationship to his client.

MR. GARRETT: That is the way it is presented, and you are saying compatibility or auditing-related skills have nothing to do with independence.

MR. KLION: No, sir, I don't think I said compatibility had nothing to do with it.

MR. GARRETT: No, you didn't; I did.

MR. KLION: Auditing-related skills are not the criterion that I would use. That won't keep me from lacking independence.

MR. GARRETT: I understand that point, but perhaps unrelated to independence, should there be some professional rule with respect to the sort of things that firms that hold themselves out to be CPA firms and skill in auditing should engage in?

MR. KLION: Yes, I think compatibility is

a very logical one. Activities that relate generally to the control structure of the environment, the client--the services that derive out of that require a pretty broad spectrum over the management problems of the company.

Unfortunately, problems don't compartmentalize themselves very easily, and to solve problems which clients request us to solve require a diversity of skills that aren't easily defined within the constraints that the amendment sets forth.

But certainly compatibility is one that I would urge. I don't think we ought to find out what kind of soap powder the housewife wants to buy and take that kind of poll.

MR. GARRETT: Do you think we need a rule on that or recommend a rule?

MR. KLION: Yes, I think a rule on compatibility. I have no problem with that.

MR. McCLOY: Wouldn't we be charged with having just as slippery a test as you have with relation to skills, if you did that?

MR. KLION: No, sir.

MR. McCLOY: How do you define it? We had some difficulty defining compatibility, yesterday.

MR. KLION: I am sure that is so, Mr. McCloy. You observed before that it is very hard to define independence. It is a state of mind.

I find it distressing that in all of these conversations the word "integrity" never comes up, and that is the hallmark of any professional.

I guess in today's environment it is easy to observe that we are all considered rascals, or a great many of us are considered rascals, and without any question there are rascals in every profession, but we are defending against all of us being rascals, when, in fact, that isn't really the case.

I don't know how you define integrity. My father used to tell me that the test of an honest man is what he would do when he knew he wouldn't get caught. I have lived my life on that basis, and I think that is a perfectly fine way to do it, and I yield to no one in the integrity of the accounting profession as a body. I think they are the highest grade of people I have ever encountered.

So to define compatibility is a terribly difficult task just as defining independence is.

MR. McCLOY: You are saying that the only criterion that amounts to anything now is the independence theory. Is that what you are saying?

MR. KLION: Yes, sir.

MR. McCLOY: There is no other criterion that would be relevant?

MR. KLION: I put compatibility in there.

MR. McCLOY: Compatibility.

MR. GARRETT: But you wouldn't hang it on independence. That is to say, you wouldn't say for independence you must limit the scope of your services to those that are compatible?

MR. KLION: I don't think compatibility clouds independence. I just don't think it is appropriate.

MR. GARRETT: Room for compatibility restrictions must have their base in something else, than independence.

MR. KLION: Yes.

MR. GARRETT: I have some more, but I will defer to Bill.

PROFESSOR CARY: May I say with respect to integrity, the reason it hasn't been raised, it

is assumed, and therefore, we don't need to raise it, at least, that has been my attitude and I think that is speaking for the rest.

I would like to develop a few points. Obviously, you are the largest, I believe you are the largest firm and the most diversified in the profession. Isn't that correct?

MR. KLION: We are the largest by the general numbers that are available. Our scope of practice is among the broadest. I can't speak to it precisely, but certainly we are at that end of the spectrum.

PROFESSOR CARY: I have been raising this question perhaps, too, repeatedly about what would you think about merging with a major management company, Booz, Allen or McKinsey.

Probably you don't need to because you have already reached that stage, but if you did merge with them, would that offer any new areas of activity that you do not presently perform?

MR. KLION: In the first place it would surprise the daylights out of me. It would not concern me provided I could apply to the firm that was affiliated with us the same constraints that we apply to our own practice.

You have mentioned Booz. Booz does a great many things which are wholly competitive to what we do and they do a great many things which are not competitive to what we do.

This is obviously not a value judgment on their scope of practice. It is simply describing my understanding of their firm.

PROFESSOR CARY: Such as?

MR. KLION: They do a great deal of technical research. We would not wish to do that. We don't have that competence, to use a word that we have been struggling with a little bit before. I don't think

it is compatible with our firm, but to the degree that they counsel with industrial and not-for-profit clients, as we do, in areas that broadly relate to the control structure of those clients, if there was a commercial reason for so doing, affiliating with that kind of a firm would not bother me.

I don't believe that a CPA firm ought to be 80% consulting and 20% auditing, although I would observe that most small and medium-sized practice units might have that kind of a relationship.

Their attest function is very much the smaller portion of their practice, but the perception of that in the major firms I think would be distressing.

I don't know what a proper mix is, sir. In our own firm our MAS practice is approximately 13% of the firm. Our attest function is two-thirds of the firm. That is to say our accounting and auditing function, not all of which is attest. If MAS services should be 18% or 20%, I wouldn't be terribly disturbed, and I know some of my competitors, some of my excellent competitors, have MAS departments that approach 20% of their total firm.

MR. GARRETT: Would it bother you if it got over 50%?

MR. KLION: Yes, sir, I think it would because I do think we offer ourselves as a major business service CPA firm, and I don't think we should be more than 50%, but if you ask me why 50 and not 40 and why 50 and not 60, I would be hard pressed to say.

We have grown in this area. We have rendered management advisory services for 70 years. I have on my wall a draft of a report that we did for the Boston Navy Yard in 1907 or something of that order, and we have been looked to for that

kind of work since the profession started.

Most people believe that the profession started in the attest function. That simply isn't so. The firm of Deloitte, Haskins & Sells, an enormously competent, highly regarded firm, was founded by Messrs. Haskins & Sells who did a consulting job for the U.S. Congress in the last decade of the Nineteenth century. That kind of business counseling permeated the accounting profession from the day the first man established himself as an accountant until today, so there is nothing new about rendering business counseling, business advice to clients.

As I said before, I believe in the medium and particularly smaller practice units, advice giving is the largest portion of their practice. Like Henry Moss, I fear a so-called ripple effect. I don't believe there are two standards of independence.

If you impose one on the large firms, you will impose it on all firms.

PROFESSOR CARY: What I am trying to ask, maybe this is a question of compatibility, but we are always searching for some definition of it. But where does a firm of your diversity, and which is growing, and by the way, everything is growing. I have seen the emphasis is on growth. I mean, growth and success at the same time. Where do you stop? Why, for instance, couldn't you go into investment counseling?

You probably move toward having more economists in your firm. I should think that is a necessary ingredient of a firm of your magnitude and distinction.

MR. KLION: For auditing purposes.

PROFESSOR CARY: Why wouldn't you move

on to investment counseling and things of that kind?

MR. KLION: I think there are several reasons for that. One is compatibility.

Was it Mr. Justice Potter who said he couldn't define obscenity but he surely knew it when he saw it?

Compatibility is much the same way. I guess there are just terrible risks in investment counseling, and most people don't do it terribly well. It only gets very close--

MR. GARRETT: The risks are the customer's risks.

MR. KLION: Not in today's litigious society. I just don't think it is a proper area of practice for an accounting firm to render investment advice.

MR. McCLOY: Would you apply a rule to it? Would you suggest that the POB should apply a rule or recommend a rule?

MR. KLION: If the rule were part of this compatibility problem which we have been speaking, I would have no problem with it.

PROFESSOR CARY: Do you see any areas directly at the moment which a firm of your character could move and should move perhaps over the next five years?

MR. KLION: Do you mean new areas which we presently are not?

PROFESSOR CARY: Right, new areas.

MR. KLION: I don't think so. I think our scope, which has, incidentally, not changed over the last ten or fifteen years, is as broad as we choose it to be because we think it responds to our perceptions of compatibility and our perceptions of what our clients seek of us.

It is very hard to be quite specific about that, Mr. Cary. As new developments come up in computers, for example, there may be things that we didn't do work 10 or 15 years ago such as tele-

communications. You can't be in computers now without having data transmission problems, and I guess you could argue that is a new scope or an extension of an existing scope. That type of thing I can perceive, but major new areas such as investment counseling, I do not believe so.

PROFESSOR CARY: I have one other question in this area, if that is all right. I don't want to take too much of your time, but it relates to the point made by Mr. Gunders yesterday who is here, I see, and I think it was new to us, or at least it was new to me. Insofar as he indicated, and perhaps I am misstating, Mr. Gunders, on the ASR-250, I believe you were referring to, and the indication that in the near future there would be this possibility that clients would be judging the auditing firm in part on whether or not or what areas of MAS and other services they were performing, and that that in turn might likely affect the possibility of a firm like your own of being selected.

Have you found any evidence of that? He seemed to indicate that there was evidence of it.

MR. KLION: There is no question that there has been evidence of it, and I would suspect that every firm in this room that has major management consulting practice with SEC clients has already seen some evidence of it.

The rule, as I understand it, provides that proxy statements issued subsequent to September 30 of this year will disclose whether the audit committee of the Board, and the Board itself, has pre-approved all non-audit services as defined that were rendered to the company by its principal accountant, will itemize each of those services and will indicate the percentage of fee of each service as a numerator of a fraction, the

audit fee being the denominator. The relationship, I must say, escapes me as to relevance, but that is what we are talking about.

Now, to put that in cold terms, if you have a client whose annual audit fee is \$200,000, and that is a very nice client, indeed, asks you do do some work with respect to the cost system of a small plant in upstate Iowa, the fee for which is \$8,000, according to ASR-250, there must be disclosure as to whether or not the audit committee pre-approved that work since \$8,000 is obviously more than 3% of \$200,000. Such an engagement is a perfectly normal, routine type of service. I postulate a service that would not be under anybody's proscription of service if you accept the fact that MAS does exist, and you are now placing management in the position of saying--management now, not the board--of saying, "We have a choice. We can go to our board and get such prior approval, all the while convening a meeting of the auditing committee which may be spread all over the country, and then disclose the fact that we had done so in our proxy statement, or we can go to another firm and have the same service done, presumably with the same degree of quality, possibly more expensively because of the startup cost and make no disclosure at all in the proxy statement."

I submit, sir, that it will take a very confident and secure management to opt for using the principal accountants when disclosure must be made, and go through that routine, rather than going to a competitor when no disclosure need be made.

There isn't any firm here who hasn't been affected by it. I know of my first-hand knowledge of at least three situations already

where we have been told we will not be considered for work for just this reason.

PROFESSOR CARY: It seems to me, therefore, that yours being the most diversified would be the most jeopardized. I mean, that seems to follow. I don't know.

MR. KLION: No, sir, I don't think diversity will be the impact here.

We are, as far as we can tell, not the largest MAS practice among the big eight firms, so-called, and I think the other question that will have to be asked is: What percentage of the work is done for SEC registered clients, and all other clients? I guess most of us who have labored in these vineyards have been concerned that we haven't done enough work for SEC clients rather than having done too much work for them, so I don't know who will be affected more, but there is no question that all of us will be affected.

I think what the SEC has done by rule making is to indirectly try to achieve what appears to be the desire of our critics.

I have no doubt that there are a number of clients who will believe that this is--forgive me--a bureaucratic requirement that they are willing to live with, and they have sufficient confidence in the posture of their principal accountant and their competence as to go through the procedure that I have outlined, but there is no doubt that some will not. All that means is if we are accused of being too aggressive now, if I may use my friend, Henry Gunders' firm, that we will look after PW clients and PW will look after PMM clients. I am not sure that is particularly in society's interest.

MR. McCLOY: We have had several priorities suggested to us. You suggested one. He suggested

one yesterday. You kill ASR-250 and we will acquire merit.

MR. KLION: I share his view as to the distressing impact of it, I will tell you that.

(Off the record.)

PROFESSOR CARY: One other area that I am not alone, I think, in wanting to discuss, we have had these discussions by the actuaries yesterday, and we somehow on the points of difference we have never been able quite clearly to identify.

I understand you have a fairly large actuarial service.

MR. KLION: Yes, sir.

PROFESSOR CARY: You are undoubtedly keenly aware of the positions taken by the actuaries. How do you respond to their basic criticisms?

MR. KLION: The actuary and the accounting profession really started together. The first professional association of the two professions was in Scotland, the Society of Actuaries and Accountants, or some name of that nature, and they have been interrelated for 125 years.

Actuarial work is obviously quantitative in nature, and by the narrowest scope definitions that one would want to provide, including accounting-and auditing-related skills, as a functional criterion, that is a rational relationship.

I am not an actuary, and perhaps I don't plead the case as well as my actuary partners would, and to that end I would refer the Board to an article that appeared in the July issue of the Journal of Accountancy, July, 1978, written by our National Practice Director of Actuarial Services and our Vice Chairman for Accounting and Auditing, Mr. William Dreher and Mr. Clifford Graese respectively. I incorporated that article in my testimony. Let me

say briefly to respond, Mr. Cary, we believe, and our actuaries believe, just as I have described before, that one does not make a management decision.

One requires in doing competent actuarial work that the client understands the substance of the actuarial assumptions and the alternatives that are available to him, and then makes a judgment based on the alternatives that are available.

It is the actuary's responsibility to educate his client that way, and it is the client's responsibility to be educated that way.

One of the concerns that has been expressed, I am sure, is that if the auditor and the actuary are in the same firm that, in essence, the auditor is auditing his own work, as it were. But such is not the case.

As I indicated in my introductory remarks, I served on a task force that led into SAS-11 which deals with the use of non-accounting specialists. When an auditor examines actuarial work, he is not auditing the actuary. He is trying to establish the actuary's qualifications and credentials. He is trying to establish that alternatives have been set forth and that assumptions are rational.

The auditor does not have the competence to make actuarial judgment because he is not an actuary.

I am sure the illustration has been used of the geologist or the gemologist or any other kind of a specialist, and the actuary is the same.

If the actuary offers, as many do, that only an actuary can understand what an actuary has done, then they sort of have a Catch 22 argument. Then they can't accuse the auditor of auditing his work because by definition an auditor is not an actuary, and therefore, he doesn't understand what an actuary is doing.

As I say, I would prefer that the Board for its research consider Mr. Dreher's and Mr. Graese's article because it is a very logical exposition, I think, and it is done with a great deal more scholarship than I have just done it.

PROFESSOR CARY: I gather that they think it is practically impossible. That is their point. It is practically impossible to inform the management. In other words, you are willy-nilly making management decisions.

MR. KLION: They say that, Mr. Cary, but they carry water on two shoulders.

There is a citation in that article which is relevant. As you know, the actuarial profession divides itself into several pieces. One relates to employee benefits, using that phrase broadly; one to the life insurance industry. There is also some casualty work as well.

There is a precept in the actuarial profession that actuaries impose upon themselves, that says when an actuary is employed by an insurance company, and he provides actuarial services to his employer, (speaking of independence and clouds and appearance, of course) that in fact, the employer is his client and the executives and the shareholders and trustees and directors are all his clients, and it is required of him that he inform those people as to the assumptions that he has made, the very things that I have just cited.

I don't believe you can argue that that is an appropriate environment for one piece of their profession but not for another piece. If they can persuade trustees and shareholders and executives as to the assumptions that they use, and they require that in their codes of behavior, we believe that is fine.

All we are saying is that that particular approach to professional services is a decent one and should be applied to all of their services. We don't agree that you can't inform clients because, in fact, we do, and we obtain from clients confirmations of the fact that they do understand what we are talking about.

PROFESSOR CARY: Thank you.

MR. GARRETT: One last thing, Mr. Klion. The suggestion was made yesterday, I believe by Mr. Vanatta of Arthur Young, who had the same basic view that you expressed, the nature of the skill or the nature of the service is unrelated to independence and independence should be the criterion. It was also suggested that perhaps something could be done to beef up or extend the peer review to more expressly examine into MAS as it relates to independence.

We didn't have all the time in the world to explore it with him or with anybody else, but we have been puzzled in thinking about it as to just what a peer review team could do.

It is easy enough for them to identify the services that the firm provides. Does it seem practical to you that they could do something that would have some meaning to it in the way of reporting, whether the firm did or did not participate in management decisions to a degree of compromising their independence?

MR. KLION: Yes, sir, I think it is because we try to do the same thing within our own firm, and most of my competitors do the same as well.

There is no question that it is somewhat more difficult to try to re-establish after the fact the environment in which a problem has been presented and the solutions that have been offered. But you certainly can measure--we do, and we have very successful work programs to which this Board is quite welcome--

to measure the administrative controls that are placed upon the engagement, the criteria which we impose upon our engagement teams, the extent to which alternative judgments have been reached because we document those, the offers of alternative recommendations to our clients. It would not be hard to include to certain specific constraints which might be established by the SEC Practice Section or this Board and the SEC, to include those in our work programs.

We read all of our proposal letters, the fact-finding which is documented in our work, the reports that are submitted to see whether they hang together logically, and whether there is a rational presentation of the case.

We also include in our own firms, and I think other firms do as well, an on-the-job quality assurance review. That is to say, during the course of an engagement we will send in a review team.

We put constraints on jobs in excess of certain limitations, and in greater complexity to be sure that judgments are properly rendered.

MR. GARRETT: So there is something in the peer review team.

MR. KLION: I think there is something that could be done. It is not quite the same thing as auditing, but I would be perfectly comfortable with it, and we would be very happy to submit to it.

MR. GARRETT: Thank you very much.

Go ahead, Dick.

MR. STARK: Since Mr. Klion's firm is so heavily engaged in the actuarial work, I wonder if it wouldn't be worth pursuing that just a moment further.

Yesterday one of the witnesses explained that an auditing firm that is reviewing actuarial work will go further than merely testing the

qualifications of the actuary.

Does your firm generally apply tests and make examinations beyond the qualifications of the actuary when your firm is auditing, say, an insurance company or is involved in looking at the pension plan?

MR. KLION: I am not sure I quite understand your question, Mr. Stark. We do have insurance actuaries on our staff who are partners, and I might add that some of them are certified public accountants as well as Fellows of the Society of Actuaries, and they will test actuarial valuations as part of the audit activities. They do not provide those services to audit clients who do not have either their own in-house actuarial services or use third party actuaries to provide it.

That is to say, we are not the principal source of that actuarial service, but we satisfy ourselves as to the competence of the actuarial work because after all, in an insurance company, that is the very guts, the very heart of the balance sheet.

We will do that as well as satisfying ourselves as to the quality of the actuarial assumptions that are made and the actuarial services that have been rendered.

MR. STARK: So you go beyond SAS-11?

MR. KLION: Yes, we do.

MR. STARK: In the case of an actuary other than your own where the actuarial work is other than your own firm?

MR. KLION: Yes.

MR. STARK: In the case where your firm provides the actuarial work, how do you go about--I guess you satisfied yourself in SAS-11 because you know your own actuaries, but how do you go beyond the qualifications?

MR. KLION: As I say, in insurance companies

we don't do the primary actuarial service on the accounts to which we attest.

MR. STARK: You mean as a matter of principle, you do not?

MR. KLION: As a matter of principle we do not. On the benefit side, to the degree that we attest to pension plans, for example, where our actuaries provide valuations, we satisfy ourselves as though they were non-PMM actuaries.

There is some professional literature that requires that special care be given because of the potential appearance of this relationship, and we satisfy ourselves accordingly.

I might add, incidentally, that the Department of Labor which has jurisdiction over ERISA, has quite explicitly indicated that an auditor and an actuary being in the same firm does not create a conflict of interest or a cloud on independence.

There is a specific regulation which is again cited in that article. It is quite explicit on the subject.

MR. STARK: But you would be having different people on your audit side than the people on the actuarial side, and applying as you say, extra care because of the self-audit potential.

MR. KLION: That is correct. We have auditors who are trained in the area of auditing pension plans and other types of products of actuarial services who are especially trained for this purpose.

MR. STARK: And they would apply, I suppose, in principle, the same tests to actuarial work done by some one other than your firm.

MR. KLION: Absolutely, because the bulk of the pension plans which we audit, we do not provide actuarial valuations for.

MR. STARK: Do you find the proposals of

the Executive Committee as to insurance actuarial services and employee benefit consulting services to be unduly restrictive on your firm?

You have already said that you have conformed. I take it that was done as a matter of policy and that it has not had a material impact on your firm, but as a matter of principle, do you find these proposals unduly restrictive?

MR. KLION: Without trying to be redundant, Mr. Stark, I find the structure of that amendment conceptually incorrect. Now, if you pass that point and say, "Here is what I have," no, sir, I do not. That caused us no restriction at all. It is the concept that I have a problem with, and if I can make one more comment to that, there is an ill-used cliché about salami slicing and that is what we are afraid of. We think the concept is wrong, but we can live with it and the interpretations that come with it in peace, let us get on with our business. But if this becomes the point from which we now make additional concessions, that we are building a house on a very poor foundation in my view and that is what I object to.

MR. STARK: You salami was not sliced by this one but it will be by the next one?

MR. KLION: No, sir. It was modestly by search, unwisely in my view because I think you are permitting us now to do unprofessional work instead of professional work, and we won't do that in any case. But I think it is an incorrect constraint. I don't think it accomplishes what you seek to, but I am willing to live with it explicitly, and we are living with it right now.

MR. STARK: Do you think that the rule should be expanded to say that a firm will not audit its own actuarial work for insurance companies? You

say you don't do it as a matter of principle. That is only as a matter of internal policy with your firm?

MR. KLION: I don't think we are limited. I don't think we are the only firm that says that.

MR. STARK: You say you can't do it.

MR. KLION: You can't audit your own work now.

MR. MATUSIAK: What about the employee benefits area?

MR. KLION: In employee benefits the wording is a little close. The employee benefits, the ERISA rules as I understand them require that the actuary prepares the reports for the plan. I think that is close to the wording, which we may, in fact, audit.

We impose the same requirements on that as we do as I have described before.

We believe that the plan as an entity to be audited should understand very clearly what it is that has been done, and agree with the work to be done-- the assumptions and the presentations and the alternatives. There is no solution in actuarial work as I understand, and there are alternatives from among which choices are made, and we do require that our people inform their clients accordingly.

MR. MANZONI: We were told yesterday that in the area of the employee benefit actuarial determination, the law requires that the actuary himself file the report with the Department of Labor but also that the determinations and the actuarial assumptions are those of the actuary and not those of management.

Do you agree with the statement, or is it something that you are sufficiently involved in to be willing to give an answer?

MR. KLION: I am not sure I can speak as credibly as I would like to, Mr. Manzoni, because I am not an actuary. I would be happy to get you a

specific answer. If you will just give me one second, I think there is a reference to that in here.

The reference here, it says: These principles of professional conduct have been reinforced by ERISA which requires that an independent CPA be engaged on behalf of all plan participants to conduct an audit of the financial statements of the plan, and that an enrolled actuary be engaged on behalf of all plan participants to prepare the actuarial statements specified in Section so-and-so of the Act.

I cannot speak more precisely than that. If you like, I will see that you get that information or at least give you my perception of it anyway, but just to conclude, the Department of Labor which has regulatory responsibility for ERISA has considered this specific issue, that is, independence, and has concluded in Regulation 2509.759 that "The rendering of services by an actuary associated with an accountant or an accounting firm shall not impair--shall not impair the accountant's or accounting firm's independence."

MR. MANZONI: It was really a different question. What I was getting at, in all these other MAS areas we are told about the role of the accounting firm and the role is advisory.

It would seem that if the statements made by the actuaries are correct, there is departure from that role in this one narrow area.

MR. KLION: If, as you describe it, I guess you could argue that way. Again, I believe that, at least in the way we practice, our clients have available, admittedly through our education and their willingness to be educated, the alternatives that are offered, and make those judgments before the die is cast, as it were.

MR. GARRETT: Thank you very much, Mr.

Klion. We appreciate very much your views.

Incidentally, we have two cancellations for this afternoon.

Let us now take 15 minutes for coffee.

(A short recess was held.)

MR. GARRETT: Mr. Elliott. We will now resume with Mr. Elliott and Mr. Mitchell from the MAS Executive Committee and MAS Division of the AICPA. Will you proceed, please.

MR. MERLE S. ELLIOTT: I am Merle S. Elliott. I am a CPA. I am active in the AICPA's MAS Division. With me today is John Mitchell who is the Director of the MAS Division of the Institute. I have also asked Mr. Stan Klion who just testified before you to join us. He is the Chairman of the MAS Executive Committee of which I am a member and on whose behalf I am here today.

The Executive Committee has previously submitted written testimony which you have. I will not read that. It is my intent today to give a brief summary of the points that were made in that presentation. The MAS Executive Committee is the AICPA's official voice on MAS matters.

By way of personal background, I am the Executive Partner of Smith Elliott Kearns & Company. I founded my own predecessor firm as an individual practitioner in 1956 and created along with my partner in 1963, by merger, the firm that is presently so named. We have a staff now of about 60 people, and we practice in Western Maryland and South Central Pennsylvania. For the past 22 years, since I formed my own practice, I have constantly been involved in advice to management. In fact, that was my very beginning in public accounting. I was in public accounting on my own account for several years before I had my first audit client. I believe that this advice to management is considered by our clients to be the most important service that we render.

Many of our clients today receive such service from our firm by way of background of the firm; we have about 22% audit work, about a third tax work with the balance consisting of accounting services and advice to management. Some portion of our audit work might be construed to be advice to management since we don't necessarily break down in full detail work done by auditors when they are involved in advising clients.

Our clients ask for advice. They expect it. Such advice is in areas that are not necessarily related to the audit function. We have full-time personnel to provide the more formal MAS advice, and we have a fairly significant staff

that provides accounting services and tax advisory services.

Through our affiliation with approximately 85 other firms, we have more sophisticated, more highly specialized professionals, to provide the more highly structured MAS services and more complex engagements.

My own service to clients is largely the sort of thing that does not relate to the conduct of audits. I have not been personally involved in auditing other than as an advisor to auditors, for some time.

As I said, my purpose is to summarize the Executive Committee's formal statement previously submitted to you. I intend to emphasize the conclusion of the MAS Executive Committee, that the provision of MAS does not threaten audit independence.

Additionally, as a subsequent report from the Institute, we have submitted on behalf of the AICPA Private Company section of firms their comments with respect to this hearing, emphasizing certain points that they have that relate to matters which I will comment on a little bit later in my presentation.

First, I would like to point out that we consider that there is no basis for a prohibition of MAS services. We consider that surveys of attitudes are not evidence. Factual research has not disclosed any cases of an impairment of audit quality or independence as a result of providing MAS services.

I won't go into lengthy quotes about the research of the Cohen Commission which is probably the most definitive factual research with respect to that topic. But as has been pointed out to you before, there has been no empirical evidence of an impairment of audit independence. On that basis the Commission concluded that there would be no justification for a prohibition if that were the only thing to be considered. Nevertheless, the Commission did determine that there was a significant minority that should be considered even though it could not be proven that there

was a problem, but, they further stated that, on balance, there is no justification for the prohibition of any particular service. The Cohen Commission further observed that the fears of those who express concerns about threats to audit independence decrease as their familiarity with the services provided by CPA firms increases.

We feel that it is appropriate for us to forcefully argue that there is no reason to curtail MAS services.

From my perspective as a smaller practitioner, I know that in many cases our clients would not be able to secure the services in management advisory and other advisory services if it were not for the CPA. In fact, we are in many cases the only source. We believe that without any evidence of an auditing inadequacy resulting from management advisory services that a prohibition of such services is unjustified and wrong.

In a more positive vein, let me briefly comment on what we believe are the benefits that are derived from the provision of MAS services.

We think that MAS competencies enhance better audits. We know that many of the skills that are necessary in audits with respect to the evaluation of systems controls, the analyzation of financial controls, evaluating internal controls, the application of latest business technologies and the understandings of the operations of our clients' firms are greatly enhanced by the management advisory skills that we have developed.

Our auditors better understand the signs that come from the tests, and I think it is important to realize that audits cannot completely test or completely examine every transaction in a business. Auditors test the records. On the basis of testing the records, they test the systems. They have to understand the basis for these tests for them to have validity. If they don't understand what the systems are about, they can't really do effective audits. Management advisory

services skills enhance the auditors' abilities to do a better job.

We think that the clients have a better impression of CPA firms and of auditors because of the breadth of services and the ability of CPAs to attract more competent, more highly skilled individuals into the profession.

This has resulted in improved audit effectiveness. We believe, and we think we can demonstrate, that users of financial statements better respect the audited financial statements, recognizing the high level of skills and the breadth or range of skills that are applied to support the decisions that are made by auditors in the application of their audit judgments.

We think the clients benefit most particularly. CPAs have an ongoing familiarity with the client, and as a result, are able to be extremely effective in providing management advisory services to clients.

Continuing client relationships gives a great incentive for the maintenance of a high quality standard of management advisory work. We think that in many cases, and from my personal experience, I am certain, that recommendations by CPAs made as a result of a advisory services engagement are more likely to be fully implemented (as opposed to being in a book placed on a shelf and never referred to again.). This is true because of the continuing relationship of the CPA with the client.

Following are disadvantages that would result from the prohibition of management advisory services.

The major disadvantage is the loss of the advantages (particularly from the perspective of the smaller firm) would be the business-absorbed cost increases and the difficulty in getting those services from some other source (assuming such services were even available).

Now, normally we would expect that the result of the SEC Practice Section's prohibitions with respect to management advisory services would only apply to registrant companies, but we know from past experience that that will not be true. We know that it will filter down and it will affect all CPA firms and all clients for a couple of reasons. One, two standards, two sets of independence standards, will simply not be acceptable. They won't be acceptable to our clients. They won't be acceptable to users of financial statements, and they won't be acceptable to CPA firms. CPA firms will fear a charge (or an appearance) of inferiority from a competitive standpoint, and additionally, they will be concerned about the possibility of increased legal liability resulting from the possibility that a court will later hold that the more stringent standards ought to have applied.

Though it might be possible in theory for two standards to exist, we don't believe that it is possible in fact.

Let me summarize and offer a few conclusions. Given competence and due professional care, we believe that independence is the only criterion for the rendering of services to audit clients or to other clients.

It has been pointed out previously that the profession's roots are in the early accounting and financial advisors to business. My own practice evolved from that, and I perhaps flatter my firm, but I believe that its evolution is in a manner the profession in miniature. From one client with an annual fee of \$125. to our present size with a steady increase in the percent of fees represented by auditing. We have always provided accounting and financial advice to our clients. That is how we kept them. That is how we got more.

Our firm's clients view those advisory services as the most important thing that we do.

Audits are generally imposed by third parties.

Advice to management is something that management itself seeks out.

As a profession, the MAS Executive Committee and the entire Institute is concerned about threats to audit independence. Audit independence has been one of the standards of auditing for a long time. We are concerned about any loss of independence. We have ethical constraints that address that concern.

With respect to the activities of CPAs, and their role in serving businesses, it has long been established, as amplified by the SEC itself, that advising business is a proper role for a CPA.

Decision making and management is the prerogative of management.

I would like to conclude with these comments. Obviously, we think that what we do in public accounting is an appropriate thing to do. We think that our clients agree. Otherwise, they wouldn't continue to have us do these things and they wouldn't continue to pay our fair charges and expand the services that they have us perform, (the additional services that they request of us) if they did not think these services were useful. We think we should be permitted to continue to provide these services and I certainly hope that you will agree.

Further, we strongly recommend that the conclusion of this Public Oversight Board be communicated and promulgated in such a way that the thought processes with respect to independence as it relates to the provision of MAS services be available to audit committees and boards of directors of registrant companies and other companies in assessing the independence of their certified public accountants and their auditors.

That is a very brief summary. Our more complete formal presentation has already been submitted to you, In the interest of conserving time, I have limited our oral presentation.

At this point I would like to respond to any questions that might have been suggested by my remarks or our formal testimony, or the testimony that was submitted on behalf of the private companies group.

Mr. Klion as Chairman of the MAS Executive Committee is here to further respond where that is appropriate as is Mr. Mitchell.

Thank you for your attention.

MR. McCLOY: I gather that you think that the proposals that are put forward in the Notice are unduly restrictive.

MR. ELLIOTT: From my personal perspective. Mr. McCloy, I do, and from the perspective of the Committee, we also think that they are unduly restrictive.

However, the Committee has agreed by formal action that we can, in fact, live with those.

MR. McCLOY: Live with this?

MR. ELLIOTT: Right. We don't accept the rationale, but we do accept perhaps the necessity.

MR. McCLOY: I don't think I have anything further.

MR. GARRETT: Would the Executive Committee's proposals cause a severe curtailment in the services that your firm provides?

MR. ELLIOTT: No, as a matter of fact, Mr. Garrett, they would cause no curtailment at all in our particular case.

MR. GARRETT: But I suppose anything more drastic in the way of prohibition against MAS would shatter the firm.

MR. ELLIOTT: It depends on whether we decided to continue to do audits.

MR. GARRETT: You might drop auditing?

MR. ELLIOTT: That is right.

MR. GARRETT: We keep coming back to the idea that the possession of MAS skills with firms improves audits, and yet we keep hearing that the MAS personnel don't

do auditing, and frequently aren't even CPAs.

MR. ELLIOTT: That isn't true in our case.

MR. GARRETT: It is not?

MR. ELLIOTT: No, sir, we do not have the tight formal structure that larger firms evolve into. When I started in practice, Mr. Garrett, I did everything there was-including typing the reports. Later on I found it appropriate to get a typist. Later on I employed auditors. Just recently we have added MAS skills, and our one full-time and two part-time MAS practitioners are CPAs. All of them graduated, if you will, from our auditing section.

MR. GARRETT: It seems at least conceivable that if the auditing personnel, the CPAs were also in between audits, so to speak, providing management services and advisory services to the same client, you would generate a degree of familiarity and involvement that would threaten objectivity.

MR. ELLIOTT: I certainly question that. I have had such experiences fairly recently in my lifetime. I don't believe that my integrity will be compromised. If as a result of audit, I find that a person I recommended be employed had turned out to be a thief, it does not follow, that I won't blow the whistle.

I think there is a question of integrity that must be taken into account with objectivity. As Stan Klion said earlier, I don't think that our profession is comprised totally of rascals, although, there obviously are some.

MR. GARRETT: Certainly we would not suggest that, but it is also true that some rules and ethical canons exist for prophylactic purposes or for appearance purposes, or as one of the persons yesterday said, to avoid the proximate occasion of sin.

This is most obviously true in the financial interest test of your independence.

MR. ELLIOTT: Right.

MR. GARRETT: I haven't checked the history of it, but I dare say when the principle was being established and the independence required the absence of financial interest, that nobody observed that there weren't any cases proving that the ownership of 100 shares of stock of a client caused an impairment in the quality of the audit.

The question would have seemed almost irrelevant, and I think the same idea persisted in this area.

MR. ELLIOTT: May I comment. I think that it is true that you can't prove that there has been an impairment. Conversely, we can't prove that MAS services do not cause the possibility of a threat on independence. In fact, I personally believe that in some cases, they do cause a threat to audit independence but I think the trade-off is so much worse from the standpoint of our economy of small business. That if you put these constraints on the people who are knowledgeable and can provide those services, (throw the rascals out and throw the baby out with the bath, so to speak), that the negatives of not having those MAS services are so much worse than taking the chance of maybe a little bit of appearance of the possibility of impairment. That is overcome by individual integrity in almost every case.

MR. GARRETT: Let me finish along that line of thought. You would say there is no need for the auditor to ever have a financial interest in the client, and there is an obvious suggestion of temptation, and therefore, no harm is done by prohibiting it since its being there wouldn't do any good, but when you turn to MAS, you would say the same things are not true. There is some benefit in the MAS, and while it can have an appearance of impairment of objectivity, the pros outweigh the cons.

It is that line of thinking that has led us to question the validity or the cogency of the argument

that there is no record of problems because it isn't susceptible to a record. At least, what we are worrying about it not provable, what the critics are worrying about.

MR. ELLIOTT: It would be very difficult for me to testify that I say him not do it. (Laughter)

MR. KLION: Mr. Garrett, may I comment to a question that you put to Mr. Elliott and I guess inferentially to me about the number of MAS practitioners who are not certified and how that assists in the examination.

In my own firm, we have in excess of 800 full-time professionals in MAS work. I would say something on the order of a fourth to a fifth are certified. Some smaller number are probably seeking to become certified and the great preponderance, certainly more than half, never will be certified.

Having said that, they are almost always scheduled, depending upon their skills, quite formally into our audit procedures because our audits require the kind of talents that they bring to bear.

The rationale is that if a man comes up with, let us say, data transmission skills which is important to an audit of a multilocation client, he will ask the question: I am trained as an accountant doing data processing work, and I want to keep current in my profession which happens to be data transmission, and to go through the procedure of getting a CPA certificate, which I will never practice as such, simply diverts my efforts away from what I do very well into something which has more of an appearance than a factual benefit to my career and to my clients.

We have 135 or 140 MAS partners, and the same proportion obtains. Perhaps a fourth are certified, and the rest are not.

MR. GARRETT: They directly participate in audits?

MR. KLION: Yes, sir. Not every single one of them in every audit, but virtually every audit, has MAS Practitioners if no other place than a review of the data processing center, and there are other places, too, but that is clearly the one that gets the most attention.

That is a formally structured thing. The time goes into audit time sheets or audit contracts, and they are very much a part of it.

We train people along these lines, some of whom have MAS backgrounds, and some of whom do not. We interchange our people for their own benefit. We put some MAS people on the audit staff for a year or two, and conversely, some auditors on the MAS staff for a year or two because we feel that cross-training makes them better auditors.

MR. GARRETT: So a young CPA coming in could look to a period of time possibly, that is, in the MAS Division?

MR. KLION: Yes, sir, and some of them stay in the MAS Division. Every year we probably have three or four partners who are admitted to the MAS practice who started as auditors.

MR. GARRETT: It at least offers a possibility for them of additional experience.

MR. KLION: Yes, sir. The managing partner of our Chicago office, which is our second largest office, is both a CPA and a very distinguished consultant.

The Regional Vice Chairman on the West Coast, the same observation. He is a consultant and he is certified. He brings to the management of the firm skills that we think are quite appropriate for his position.

MR. GARRETT: I stepped out of our usual order, but I might as well go on with one more question, and that is, Mr. Mitchell, I would like to know what the MAS Division of the AICPA does.

Do you promote, or do you fuss at MASers?

MR. MITCHELL: Technically, the MAS Division consists of the staff which is myself and Mr. Kuttner and a secretary, and the members of the MAS committees and task forces.

The staff's responsibility is primarily to support the committees in whatever activities they undertake, which could be the development of standards, the development of guidelines for specific practice areas, it could be assisting the Executive Committee in developing a statement such as the one submitted here. It could be considering new approaches to the education and training of MAS personnel, but our basic function is to support, the staff's basic function is to support the committee activities.

MR. GARRETT: I see. Thank you.

MR. KLION: At the risk of embarrassing Mr. Mitchell, he does it with great distinction.

PROFESSOR CARY: I've just got a couple of questions.

First of all I would like to ask you, Mr. Elliott, you have pointed out that your firm does 22% audit, and the balance is in other areas including tax and MAS.

Obviously, you can't speak for the whole spectrum, but let's take a firm of 200 professionals, and less. That would be a good cut-off point.

Are there many firms having that relatively minimal percentage of audit and time predominantly in other areas.

MR. ELLIOTT: There have been two surveys, one in 1974, the Roper survey, and one more recently, more narrow in application, that addressed just that question to the smaller firms.

It seems to follow, and Mr. Mitchell may be able to comment more definitively on this--it follows that the smaller the firm, the larger a percentage of nonaudit activities or advisory activities.

In my own personal experience that follows because, when you are a one-man organization, you have a small number of clients and you deal an awful lot of the time in helping them solve problems in their real world, and their real world is making money in their business, not getting an audit. That is a third-party imposed obligation. They are more concerned about making a "buck."

PROFESSOR CARY: Thank you for that. The other point that we harped upon a bit over a period of time, it would seem in addition to independence, many of you would accept some sort of concept of compatibility. Maybe you would accept some sort of concept of compatibility. Maybe you wouldn't. I don't know.

MR. ELLIOTT: My own personal view, sir, is that I think competence and skill and ability are the only criteria other than independence.

Obviously, we would not as a firm undertake to design a space ship to go to Mars, nor would we attempt to advise in the installation of a 370/158. (We hardly even know what one looks like). But, I could say that an IBM 370/158 is compatible, but we don't have the skill to do anything with it. We don't even know how to deal with it, but we do know how to deal with the smaller computer.

PROFESSOR CARY: As I recall, I think Mr. Klion, you said compatibility was something you might consider.

MR. KLION: I share Mr. Elliott's view. Competence is clearly the overriding consideration, but I guess you could argue if a CPA firm wished to do so, it could get competent people to take opinion surveys, and design space ships. I don't think we would do that.

PROFESSOR CARY: I just wonder. This is probably one question I should have asked you initially, Mr. Klion, because we are all searching for what we mean by compatibility.

As you take some of these forms of service which are specifically addressed in this implementation of the scope of services criteria, and apply it, for example, to such things as plant layout and product design and so forth, could

we then ask the question whether or not, at least, the limitations that are suggested here have a basis in compatibility without using the work "skills" at all?

MR. KLION: I think more so. That is to say, I agree with what I understand the thrust of your statement to be. Conceivably, we could get engineering skills on our staff, and indeed, we have some registered professional engineering backgrounds.

When we get involved, for example, in activities in a manufacturing plant, it relates to the control structure of the company, the effectiveness with which manufacturing activities are performed and the collection of data for entry into the accounting system or inventory management or things of that nature.

We might speak to the location of plants or delivery points from a cost effectiveness point of view, using mathematical techniques to come up with those answers.

We certainly wouldn't design the structure because we don't have and don't wish to have construction engineering skills, and I would say that is a function of compatibility, not a function of a skill-related criterion that spoke to independence. I guess I could argue very easily designing a building would not compromise my independence as an auditor. I just don't think it is something I should do.

PROFESSOR CARY: Therefore, in a sense you don't object to some of these limitations if you accept the compatibility theory.

MR. KLION: I do not object to the limitations, save the one in search on the basis of its pragmatics. I think the rationale that puts it there is what concerns me.

PROFESSOR CARY: Fine. Thank you.

MR. McCLOY: You might go out and hire a space expert, might you not, if you saw space was becoming a pretty important commercial activity in this country?

MR. Klion: Not likely, Mr. McCloy. There are more easily attainable targets of commercial advantage that we might do which we also elect not to because we fundamentally --

MR. McCLOY: But you wouldn't have a rule that restricted you. You would leave that to the market.

MR. KLION: We have a self-imposed rule.

MR. McCLOY: You would have your own rule, but you wouldn't have an externally imposed rule.

MR. KLION: I think there is a merit to the perception of what you do. I used the phrase before, the control structure of a company. My own sense is that is a fair set of parameters around which we would work.

PROFESSOR CARY: That is a good phrase. I am not sure I know what it means because after all even law firms, God forbid, which are most individualistic have some forms of control. Therefore, everybody has a control structure.

MR. KLION: The name of our department used to be the Management Controls Department, and I found it a very useful--it was a self-defining title. I am not sure I don't wish I still had it.

MR. MITCHELL: Mr. Cary, in that connection, yesterday Mr. Vanatta itemized the criteria that his firm uses acceptance of engagement. That is a going-in part of the control structure.

We have also heard about the subsequent review or the while the work is being done review and control structure, the subsequent review within the firm, and I think Mr. Vanatta made a strong case for peer review and applying peer review to the acceptance of MAS engagements.

I think those are the things we are thinking of when it comes to a control structure on MAS and particularly its effect on independence.

PROFESSOR CARY: Thank you.

MR. GARRETT: We, at least I, have also been exploring playing with the notion that there is some sort of notion involved that certain things are not appropriate for people to hold themselves out to be professionals in the accounting field to do. I think you could easily think of some absurd examples, but it is a little hard to imagine just how that might be phrased, and the truth of it may be since we are not looking at a list of horrible examples of auditing firms, member CPA firms that are now hawking stuff that embarrasses the profession or what-not, that we needn't really worry about it very much.

I think there is a sort of lurking principle in your own thinking, and your own decisions as to what sort of services you want to add to the auditing function, but maybe it doesn't need precise articulation, I am sure.

MR. McCLOY: Your weren't suggesting that you put another criterion of absurdity? (Laughter)

MR. ELLIOTT: Or lack of it.

MR. GARRETT: There might be a marketplace function, too. Perhaps an auditing firm that was also known to be hawking debit insurance around the neighborhood or what-not would lose standing so fast.

MR. McCLOY: Sort of the department store idea.

MR. KLION: There are management consulting firms that deliberately engage in renting management. They are quite good. There is one in Philadelphia and one on the West Coast, and their purpose in being is to, in essence, rent management to troubled companies.

Most management consulting firms quite clearly avoid that type of procedure, but there are at least two quite reputable firms that do that.

MR. GARRETT: There are bookkeeping firms, too, or accounting firms that don't or ought not to hold themselves

out, at least, as auditors with respect to the same company.
Not those of any size, I presume.

Have we any other questions?

Thank you very much, gentlemen. We appreciate
it.

MR. ELLIOTT: Thank you, gentlemen.

MR. GARRETT: Mr. James A. Korreck.

MR. JAMES A. KORRECK: My name is Jim Korreck. I am Chairman of the MAS Committee for the Illinois CPA Society, and I want to thank you for allowing me the opportunity to present to you the views of the Illinois Society with respect to this most critical issue, that of limiting the scope of services that CPAs are allowed to perform.

The Illinois Society represents over 11,000 active members. As Chairman of the MAS Committee, the responsibility for developing a position paper fell upon our committee. I can assure you that that responsibility was not taken lightly. We spent many hours deliberating these various points arguing, both pro and con, for and against, the various positions, most of which have been presented in the last day and a half before you.

In a committee such as the Illinois Society, we are a little bit unique. The committee is made up of representatives from different firms and different viewpoints as a result from different firms having different viewpoints.

As a result, the committee evaluated several positions before reaching the final position.

The first position paper adopted by the committee paralleled the logic of the majority of those who have been presenting position papers here today and yesterday. That was, that the sole criterion should be independence and competence. A CPA should perform those services which do not jeopardize his independence with respect to the audit and those which he is competent to perform.

This position was based on the following factors, many of which have been presented again before.

There is absolutely no factual evidence to substantiate the allegation that independence has been

impaired through the provision of MAS services.

It is also the firm belief of our committee that the CPA enjoys a privileged and unique position of trust with respect to users of financial statements.

It is also the feeling of the committee that there are adequate controls within the profession and outside the profession, to insure that independence is protected.

We also feel that there are positive benefits to be derived by the client and the public when the CPA is allowed to perform management advisory services along with the audit function.

The MAS function has evolved to the status it has today not because of some Machiavellian attempt to control all management services but rather has evolved in response to the needs of the profession and our clients. This need has been precipitated by two major factors, one, the advance of technology and secondly, the technical awareness of management. We are constantly in a changing environment. Fifteen years ago computers were not even a factor. We wouldn't even have considered them in our audit. Today it is absolutely essential that we understand computers and their impact on the controls of a corporation.

We have developed statistical techniques which we employ in auditing to assist us in providing a more comprehensive audit, more objectivity of criteria. For example, use of statistical sampling.

Our clients have become more educated, more knowledgeable in advanced techniques. They want and they look to their CPAs to provide them with assistance in implementing some of these advanced techniques that they perhaps have heard about in college, have taken some courses on, but do not fully understand. They are asking for us to assist them in employing

these or implementing these techniques to help them better manage their corporations.

The committee points out, in its final position paper, that it accepts the fact that there is a significant minority who believe that independence in appearance may be jeopardized when a firm is permitted to practice diverse and unrelated fields. The final position of the Illinois Society reads as such. CPAs should not be constrained from providing for audit clients any services which, one, do not compromise audit independence, and two, which utilize accounting-and auditing-related skills.

For non-audit clients, the constraints limiting services to those related accounting-and auditing-skills are not applicable.

I would be more than willing to answer any questions that the committee has.

MR. McCLOY: I don't think I have any.

MR. GARRETT: You came back to what is substantially the Executive Committee's proposal, did you not?

MR. KORRECK: That is correct.

MR. GARRETT: Not necessarily endorsing their analysis of various tenets but accepting the principle of accounting-related skills.

Why did you do that--the committee?

MR. KORRECK: I think it is evident from the testimony that you have received today and yesterday that although there is absolutely no question about independence, and the provision of MAS services, there is the compatibility factor.

We don't believe that CPAs should be involved in services which are not related to accounting and auditing.

MR. GARRETT: Anything that would require people with completely different types of backgrounds

and training you think would be inappropriate?

MR. KORRECK: We feel we have the opportunity to get into that field, but it would not be compatible with the image of the CPA firm as we believe it to be.

MR. GARRETT: That is really a bow to the perceptions of the significant minority, that the Cohen Commission referred to.

MR. KORRECK: Yes, it is. Our first position paper said that there should be absolutely no controls whatsoever, but we felt that we were avoiding the issue. The fact of the matter is that there are people who have this perception and what can we do to alleviate that misperception? I can tell you that there were some heated debates going on and that a "significant minority," on my committee, felt that we are succumbing to external pressure.

But in light of the real world, as we see it, it is essential that we limit somehow the scope of services on a compatibility basis, not as it impacts on independence.

MR. GARRETT: We were not privy to the deliberations of the Executive Committee, but we get the impression that your reasoning rather paralleled theirs.

MR. KORRECK: Yes.

MR. GARRETT: And perhaps they weren't too thrilled with their own logic either, but they saw the necessity to adopt some sort of standard to cut off at least--I don't want to say abuses, but cut out the things that cause the most alarm and suspicion on the part of the public.

PROFESSOR CARY: And as I see it, the way you have framed it, compatibility and skills are rather co-related. In other words, it is something that is deemed incompatible because it requires a new skill.

MR. KORRECK: I avoid the use of the word "skill" and prefer the expression that Mr. Klion used, accounting and auditing related and control related. Control is an important aspect of the audit, and I think, for example, performing inventory control studies is well within the scope of services that a CPA firm should provide.

PROFESSOR CARY: One other point, just to get your reaction, since you are representing Illinois group and a very large number, what about size in terms of relatively--I have asked this question before--relatively small firms? How do you find the percentage of activity in those firms generally to be?

MR. KORRECK: There is no question that the smaller the firm, the greater the MAS services provided.

PROFESSOR CARY: That seems to be accepted by you, too?

MR. KORRECK: Oh, yes, very definitely. There is no question about it. The problem is that these may not be formal MAS engagements, but rather informal engagements.

MR. GARRETT: What is your own affiliation?

MR. KORRECK: I am with Harris, Kerr, Forster.

MR. GARRETT: I see. Did your committee consist of people from small firms?

MR. KORRECK: Yes, we had 18 members on the committee. We had six who were Big 8 representatives, five national firms, non-big eight, and the rest, six local practitioners and one executive search consultant.

MR. GARRETT: Could you break down the vote according to those? (Laughter)

MR. KORRECK: No, I can tell you that it was very close.

MR. GARRETT: I wondered about your willingness to make the concession to this significant minority,

whoever they are, whether it was predominantly a big firm willingness or--

MR. KORRECK: No, it was evenly split.

MR. GARRETT: Evenly split.

MR. McCLOY: Are there any other elements that you think that this Board could recommend that would enhance the concept of independence? I have asked that question before of others. Is there anything that we can do to improve the credibility and the actual fact of independence that this Board might recommend, in your judgment?

MR. KORRECK: The Cohen Commission recommended education. I would be lax if I didn't suggest that we better educate the public, but I accept the fact that that is almost impossible. We can't even educate the judges, much less the general public, so in answer to your question, no.

MR. McCLOY: No, you don't have anything.

MR. GARRETT: Not all lawyers are beyond reach.

There will be education, I suppose, at least with respect to the '34 Act active reporting companies in proxy rules, but in a sense it may only display the alarming side rather than the other.

I believe that completes our questions.

Thank you very much, Mr. Korreck. Thank you for coming.

Mr. Dowell, thank you for coming. Please proceed.

MR. LARRY L. DOWELL: We appreciate the opportunity to present our views.

By way of introduction, I am Larry Dowell, a partner and the Management Advisory Services Coordinator of McGladrey, Hansen, Dunn & Company. We are a regional CPA firm with 31 offices in seven Western and Midwestern states. We employ approximately 800 people and of those 27 are full-time management advisory services specialists.

MR. McCLOY: How many?

MR. DOWELL: 27. Of those 27, approximately half are CPAs and have come up through the audit ranks of our CPA auditing practice or other CPA firms. We have performed management advisory services in some form for our clients since the establishment of the firm in 1926. We serve over 23,000 clients, approximately 30 of which are Section 12 SEC clients. So the vast majority of our work is performed for non-SEC reporting clients.

MR. GARRETT: How many clients?

MR. DOWELL: Approximately 23,000.

MR. McCLOY: Of which 30 you said are SEC clients.

MR. DOWELL: 30 are SEC reporting clients.

By further way of introduction, I am a member of the Iowa Society of CPAs, the Illinois Society of CPAs, a member of the AICPA Management Services Executive Committee that presented their views, and I am Chairman of the Management Advisory Services Committee of a group of CPA firms called Associated Accounting Firms International which is composed of firms with various sizes of practices throughout the United States and several other countries.

The views that I am presenting are my views and my firm's views. We did provide the written comments in response to your request for information.

I would like to just very briefly highlight some of the things that we consider to be most important.

We have provided written comments in response to your request for information and views concerning management advisory services by CPA firms and we would like to emphasize several of our comments. These points are:

We do not believe that the providing of management advisory services to an audit client compromises the auditing firm's independence; it only creates the appearance of compromising this independence to a very small audience.

We believe that the question of scope of services should be directed toward that of role rather than the proscribing of specific services based on the functional or technical aspects of the services performed. In this regard, we feel strongly that the role of the CPA firm in providing these services to its clients should be advisory and providing technical assistance, and should not include participating in the client's management decision process or providing ongoing operating assistance.

As business and their related systems and governmental regulations become more complex, it will become increasingly important for CPA firms to be able to staff and make available the needed expertise to satisfactorily perform audits of their clients' financial statements. The maintenance and continuing development of these needed skills requires that firm personnel possessing these skills be given opportunities to develop, refine and maintain the needed skills. During recent years we experienced needs for additional skills in connection with audits involving sophisticated data processing systems and some of the various types of operational audits and reviews requested and needed by governmental agencies

of various types. We believe that this can be best accomplished through retaining these individuals in a management advisory services practice which utilizes those needed skills in performing other services for clients.

We believe that any restrictions of management advisory services for publicly-owned audit clients will eventually affect management advisory services for all clients, regardless of whether the client is public-owned. We fear the precedent, that regulators will attempt to continually increase the restrictions.

Because we believe that eventually any proscribed services will spill over to these services performed for all clients, we believe that the proscribing of management advisory services could be very detrimental to small and medium-sized companies, whose CPA firm is probably the only logical source for obtaining that needed advice and assistance on an economical and practical basis. The innovator, the entrepreneur is already discouraged by an excessive number of regulations and "don'ts." One more would increasingly discourage him. Concern about this possible spill-over effect is perhaps our greatest objection to the proposed proscriptions.

We would be happy to respond to any questions that the Board would like to ask concerning either our written or oral responses.

MR. GARRETT: Thank you. The association to which you belong, your firm belongs, Mr. Dowell, do you take advantage of each other's special skills in the MAS area?

MR. DOWELL: We do.

MR. GARRETT: If some of the members of the association have a skill that you do not have, you would draw upon it?

MR. DOWELL: Right, and some of the firms

who belong to that association are small firms who do not have full-time specialists on board, and we continue to receive requests for help.

MR. GARRETT: Your skills would be available to them then if they had a client that wanted that sort of help?

MR. DOWELL: Right. We assist a number of those firms every year.

MR. GARRETT: On the other hand, that would be a non-audit client with respect to your firm, wouldn't it?

MR. DOWELL: We would be performing a service for that other CPA firm.

MR. GARRETT: I don't know whether I am asking you a sensitive question or not, but do members of the association plan the development of skills?

MR. DOWELL: One of the purposes--

MR. GARRETT: You say: "We need a particular skill. Let's decide who is going to have that?"

MR. DOWELL: One of the purposes of the organization is the banding together so some of these skills do become available on a basis that they feel comfortable with.

The association has a number of professional education programs, joint sharing-type programs, that are really geared to increasing the skills of the firms represented.

MR. McCLOY: Do you do recruiting?

MR. DOWELL: We do a very minor amount of recruiting. Most of our work in that area is limited to interviewing.

MR. McCLOY: For financial jobs?

MR. DOWELL: For financial and data processing jobs, providing a client with our opinion as to technical skills.

MR. GARRETT: Can you observe any relationship between the availability of MAS services and the gaining of clients, the retaining of clients or the loss of clients because of the absence of it? Can you see it or feel it as a competitive factor?

Mr. DOWELL: I feel a competitive factor is whether you can provide full services. I think that with some clients this relates back to being able to adequately handle the audits to cope with their systems.

PROFESSOR CARY: Just a question. Of course, your firm is a very substantial size, but when you look, out in your area, you may be aware of much smaller firms. Would you confirm the statement made in the past that as a firm gets smaller, the non-audit role of the firm increases?

MR. DOWELL: I believe I would share those views. I think the management advice provided by the smaller firms is probably a higher percentage than larger firms.

PROFESSOR CARY: Despite the fact, just taking your own, you have 27 MAS people out of 800, and you are smaller than the big eight considerably, but, therefore, a larger percentage of your work is not of MAS work, is it?

MR. DOWELL: Right. It is not. I believe in a couple of the surveys that were referred to, there was a very high percentage by some of the smaller firms while some of the medium-sized firms dropped down to a smaller percentage.

MR. GARRETT: As it gets smaller, it seems to vary a lot according to the accidents of the particular background of the dominant partners.

The 23,000 surprises me. How many clients does Price Waterhouse have, Mr. Gunders?

MR. GUNDERS: A very small fraction of that.

MR. GARRETT: You don't have 23,000 clients?

MR. GUNDERS: Nowhere near.

MR. DOWELL: This would be total clients.

MR. GARRETT: Where do you turn to for
management consultants for keeping track of the 23,000?
(Laughter)

MR. DOWELL: We keep a computer running.

MR. GARRETT: I imagine you do.

MR. DOWELL: I believe that number refers to
tax clients and clients of all types.

MR. STARK: Individuals.

PROFESSOR CARY: That includes individuals?

MR. DOWELL: Right. That would be our total
client base.

MR. GARRETT: Thank you very much, Mr. Dowell.

MR. DOWELL: Thank you.

MR. GARRETT: Mr. Hebert. We will proceed
in the scheduled order.

MR. S. BEN HEBERT: I am Ben Herbert, Chairman of the Management Advisory Services Committee of the North Carolina Association of Certified Public Accountants. I am here today as the representative of this Committee to express its views on the Scope of Services to the Board. The Committee has approved this statement, and does not require approval from any other body to present it. Although it does not require any other approval, it has been passed by our society officers, and they concur with the statement.

Some information on the make-up of the Committee, as well as my own back-ground, may be helpful to the Board in its evaluation of these comments. The Committee is composed of thirteen members, all of whom are members of the North Carolina Association of Certified Public Accountants. Of these, eight are sole practitioners or members of local firms, two are members of small regional firms, one is a member of a large regional firm, and two are members of "Big Eight" firms. I believe the mixture of firms represented on the Committee is significant to the evaluation of these comments.

I am a partner in the MAS division of A.M. Pullen & Company, a large regional firm headquartered in Greensboro, North Carolina. Prior to joining Pullen, I managed my own local firm in Tennessee for some six years. Before that, I was employed in sales and sales management with Burroughs Corporation and later with the Business Equipment Group of Litton Industries.

Before moving into the main topic, I would like to point out that the thoughts, views, and conclusions expressed here by the Committee are the collective views of its members, and do not necessarily represent the position of the firms with which they are associated.

The area to be covered is large, and has been the topic of much research and many writings in recent years. We could not possibly cover all aspects of this issue, and

make no attempt to. We will, however, address the relevance of the criteria, advantages of management advisory services provided by CPA firms, and the impact of restricting management advisory services on the profession and the public.

We would also like to point out here that the profession did not have its origins in the attest function, as stated in the Board's notice. Indeed, public accountants were performing a variety of accounting, management services, and other services for their clients before independent audits became widespread. Thus, there is historical precedent for the present day CPA's provision of management services to his clients.

We also observed that the Board's notice refers in several places to tax and management advisory services. These are two entirely separate areas of practice, and we have confined ourselves to the area of management advisory services. If there is concern about tax advisory services, perhaps separate hearings on that practice area are in order.

The criterion of independence has been in the past the cornerstone of the profession, and we believe that it should continue to be so. It is the quality which gives the underlying value to our work.

However, we feel that the second criterion, that of accounting and auditing related skills is both vague and restrictive. It ignores the variety of backgrounds and skills represented by many members of the profession, especially those engaged primarily in the field of management advisory services within many CPA firms.

We believe that requiring a CPA firm to possess the expertise necessary to perform any specific engagement with professional competence is a better criterion. This substitute criterion would allow the varied educational and experience backgrounds of many of the profession's members to be taken into

account.

A number of outstanding writings on the advantages of management advisory services exist. The most recent of these is Stanley R. Klion's article, MAS Practice: Are the Critics Justified?, which appeared in the June, 1978 issue of The Journal of Accountancy. This article is in your possession and was referred to in the Notice of Hearing. Mr. Klion makes a number of very fine points in his article, but in the interest of brevity, we will not review them all here. The principal point is that the performance of management advisory services by the CPA enhances, rather than diminishes, the quality of audits, and that seems to be the heart of the matter that this Board is addressing in these hearings. In fact, the Commission on Auditors' Responsibilities in its Report, Conclusions and Recommendations states on page 95:

"An audit requires considerable knowledge about a company, its operations, and its industry. Providing management advisory services for an audit client may increase the auditor's understanding and knowledge and prove advantageour in conducting the audit."

We submit that the very fact of the auditor's independence enhances his ability to perform management advisory services engagements. His objectivity and independence, in concert with his professional competence, give authority to the findings and conclusions developed in the performance of management advisory services engagements.

The vast majority of American businesses are small to medium sized privately owned enterprises, which generally lack the resources necessary to maintain in-house capabilities in many areas of today's business activity. These areas are the ones to which management advisory services engagements

are usually directed. Many of these business feel that their best, and sometimes only, source of competent advice on a host of business problems is their CPA. Any restrictions on the scope of services of CPA's would have a detrimental effect on these businesses, and would ultimately have an adverse effect on our economy. This would clearly not be in the best interest of the general public.

The proposal that restrictions be placed on management advisory services only for audit clients, or only for publicly owned clients establishes a clear double-standard. Such a double standard would be unacceptable to both the profession and the business community because it implies that one standard is inferior to the other.

Restrictions on management advisory services would be detrimental to the profession generally, but particularly to the smaller practice units which spend a substantial amount of their client-chargeable time providing management advice. This time has been reported by some small practice units as almost forty percent of their client-chargeable hours. The economic impact on these firms and their employees is obvious.

Of particular concern to the smaller practice units is the question as to whether the definition of management advisory services (if such a definition should be formulated) should include day-to-day consulting. If this informal advice is included in some expanded definition of management advisory services, which services are subsequently proscribed, the impact on both the smaller firms and their clients will be much more serious.

The key point in the Scope of Services issue is perceived as independence. Indeed, the problem does not seem to be in the fact of independence, but in the appearance of independence. We again call your attention to the Commission

on Auditor's Responsibilities Report, Conclusions,
and Recommendations, page 102, which states:

"Except for the Westec case, the Commission's research has not found instances in which an auditor's independence has been compromised by providing other services. Indeed, some of our research indicates that performing consulting services may improve the audit function and benefit users. If the empirical evidence were the only consideration, the Commission's conclusion would be clear: The evidence does not support the theory. No prohibition of management services is warranted."

On examination, we find that the Westec case involved the rendering of advice on accounting principles, and thus was not a management advisory services engagement in the sense which has been implied in the Board's notice of hearing. We believe that the Commission felt this was not a typical management services engagement and implied as much by referring to "other" services rather than to management advisory services.

We have no knowledge of any new hard evidence supporting the assumption of impairment of independence, and in the absence of empirical evidence in support of this assumption, urge the Board to recommend that there be no prohibition of management advisory services. We believe the Commission's Report says it most eloquently on page 94:

"Decisions on the other services offered and used should be made by individual public accounting firms and boards of directors of clients."

Should the Board have any question on the comments made in this presentation, or desire amplification of any of these comments, I will be happy to respond. On behalf of the Management Advisory Services Committee of the NCACPA, I wish to thank you for this opportunity to present our views

to you.

MR. GARRETT: Thank you, Mr. Herbert.

MR. McCLOY: What, if any, menace do you see today to the concept of independence. I am not limiting it to MAS.

Do you see any area where you feel that the independence of the accountants is being impaired or any threat to it that you think we ought to take cognizance of?

MR. HEBERT: I can think of nothing that I would conceive as a real threat. I think again it is a question of appearance of independence.

I would like to expand, if I might, and endorse the comments that Mr. Vanatta made yesterday as well as Mr. Mautz' from Ernst and Mr. Klion's comments this morning.

I think that, and I really believe, that the best answer to this problem lies possibly in education. Maybe I should say not possibly, but very definitely in education. which is a difficult thing, I know, to accomplish, but I think that having the boards of directors and audit committees responsible for overlooking the independence of their principal accountants, it is a very positive step. I believe extending the peer reviews to include peer review of MAS engagements is a positive step.

Certainly while it may not respond quite as quickly I think that the marketplace is an excellent place to have our practices limited if they are to be limited.

MR. McCLOY: But you don't see any other threat to the independence of the profession that we ought to take account of?

MR. HEBERT: Very frankly, Mr. McCloy, I hadn't tried to think of that in advance, and nothing comes to mind offhand.

MR. GARRETT: Are you engaged in the MAS operations of your firm?

MR. HEBERT: Yes, I am.

MR. GARRETT: What services do you perform--not you individually, but does your firm supply?

MR. HEBERT: We are pretty well engaged in a broad range of services with the exception we do not provide any plant layout. We are not in executive search, and we are not in actuarial services.

I might expand that to say that we are not in executive search because we don't feel that we have the competence at this point to do a professional job in that area, and we are not in the actuarial services for the same reason.

I don't know that we would ever want to be in plant layout.

MR. GARRETT: One thing that has not be explored, at least at these hearings very much, was smaller firms, particularly, and I guess not just the smaller firms, is the extent to which it matters whether we are talking or the Executive Committee's proposals are considering only advisory services that reach the dignity or the formality of separate engagements for which separate statements are rendered as against what you described as the day-to-day consulting operations which presumably, at least, increased the inquiries, I imagine, that would frequently come to the audit partner or the manager that the client is familiar with because that is who he saw during the audit.

MR. HEBERT: That is correct.

MR. GARRETT: I suppose for the sake of information the audit partner might turn to the MAS people if it was something he didn't know.

Do you have a formal MAS department?

MR. HEBERT: Yes, we do.

MR. GARRETT: And do you engage in both types of services, that is to say, those in which you are retained or your department is retained for a specific piece of work

and a separate statement goes out, and then also, those in which audit partners will call you and say: "So-and-so has asked this. Can you help us?"

MR. HEBERT: The way our firm is structured, our department is really engaged in the formal type of services, formally structured services, but it is not at all unusual, in fact, it is very commonplace, for the audit partners to call some one and say, "I had a client with such-and-such a problem. What do you think I ought to tell him?" Or, "I told him such-and-such. Was that a good answer? Should I call him back and maybe tell him something different?"

MR. GARRETT: So you get both types?

MR. HEBERT: Yes.

MR. GARRETT: With the very small firms, I suppose most what we are talking about is the day-to-day consulting type.

MR. HEBERT: Very definitely.

MR. GARRETT: How about with your firm, Mr. Elliott? What is the breakdown with your high percentage of MAS?

MR. ELLIOTT: The formal MAS would be about 6% of the practice. The informal MAS, I really don't know because it gets mixed in, as I said before, in various other areas, but it has got to be 25 or 30% of our total time expenditure. The informal counseling.

In my own personal case, other than the administrative work I do for our firm, almost 100% of my time in informal advice and counsel to clients both in accounting area, the tax area and in general business advice.

MR. GARRETT: I don't know that the Executive Committee was even trying to reach the day-to-day consulting, the telephone call sort of thing, the curbstone advice.

MR. ELLIOTT: You can't deny that is exactly the same thing as the formally structured MAS, if there is an impact on independence or anything else.

I could not say that I can advise a client to take an action informally and not sacrifice independence, and on the other hand, say if I did it formally, I would. That would be unreasonable. So I think both have to be taken together.

MR. GARRETT: If there is any contamination involved, perhaps it is worse the other way. If it is the audit partner who day to day is helping the fellow run the business, if there is any possible impairment of independence, it might come more from that than it would in the formal retention of the MAS department which would perhaps, at least, in some firms be different people engaged in different affairs.

MR. HEBERT: Yes.

MR. McCLOY: You charge for all this service, don't you, by time?

MR. ELLIOTT: As Mr. Moss said this morning, we do as his firm does, we charge for our time. If we are doing something productive for a client, we charge the time.

The only inaccuracy in accumulating that would be if we charge it to an improper function, but the client will be billed for it.

MR. McCLOY: What is your chief MAS service consist of?

MR. HEBERT: About 55 to 60%

MR. McCLOY: That is compared with audit, how much?

MR. HEBERT: Our formal MAS department accounts for about 4 to 4-1/2% of our total firm revenues. Within MAS, about 55--a good 55% of our engagements are directed at computer and computer-related types of activities.

MR. McCLOY: Computer, yes.

MR. HEBERT: If I could make one further

statement, I would like to, and that concerns the ripple effect that we heard this morning. It is not in our formal response, but to expand a little bit on the two sets of standards that might be developed here, I know in Ashville, North Carolina which is where I am located, which is a very small town, relatively speaking, that we have three local firms there who have already joined the SEC Practice Division, who have no SEC clients and have probably no real prospects of acquiring SEC clients, but they already perceive that membership in the SEC Practice Section will be viewed as being superior to membership in the Small Firms Division, so I think we are already seeing some of this ripple effect.

PROFESSOR CARY: You did mention one case. You said you had no evidence, that there was no evidence you knew of, of MAS and other activities having impact on the audit performance, but you said except in the Westec case. Did I misstate that? I just wanted to get that clear.

MR. HEBERT: No, I said I knew of nothing in terms of MAS engagements, and then in fact, the Commission only found one engagement which I would not typify as an MAS engagement.

MR. McCLOY: You would differentiate that one, though?

MR. HEBERT: Yes. I would.

PROFESSOR CARY: It wasn't quite clear when you mentioned the case. I just wanted to make sure. Thank you.

DR. JOHN C. BURTON: Thank you.

MR. GARRETT: We appreciate your coming.

Proceed.

DR. BURTON: I am pleased to be here. My name is John Burton. I am currently the Arthur Young Professor of Accounting and Finance at the Columbia Graduate School of Business. I was previously Chief Accountant of the Securities & Exchange Commission and Deputy Major of Finance of the City of New York.

As I indicated in my letter, I believe that the Public Oversight Board should urge the SEC Practice Section not to adopt scope of services limitations beyond those now included in the AICPA Code of Ethics. I think the AICPA criteria of competence and compatibility have been satisfactory. I think the requirement of Section 3(a) of the requirements for membership which provides that a majority of firm members are CPAs does prevent the tail wagging the dog problem that I sense Professor Cary is a little concerned about.

Basically, I believe this for three reasons. First, there is no evidence to support any limitation. As SEC Chief Accountant, I was, in effect, the pathologist at many autopsies of deficient SEC practice and deficient auditing practice and while I found deficiencies, the disease was not based on management consulting in any case that I can recall, and I have thought back upon them.

Secondly, I think the Board and the Section should have as its principal concern the quality of audits. Independence is not a sufficient condition, although it is a necessary one, if you define independence in the sense of unbiased professionalism. If you define independence in the sense of absolute avoidance of relationships with the client, I don't believe that independence is even a desirable criteria. But in the sense that it is normally used, the sense

of unbiased professionalism, I think it is a necessary, but not sufficient condition. I think accounting expertise and knowledge of the client's business are also necessary conditions, and that consulting services clearly enhance both of these.

Fundamentally, consulting services enhance expertise and knowledge of client business in terms of the quality of personnel, where I have watched as a university professor the accounting firms attract a far higher quality of personnel because they do offer consulting services, and because of the knowledge of client business which consulting provides to auditors. In addition, the improved quality of client systems which emerge from consulting practice leads to more efficient audits. Therefore, I believe that by the test of quality of audits, the consulting practice adds to rather than subtracts from professional performance.

The third reason that I believe the Board should not urge any scope of service limitation is that I think the appearance of independence problem cannot be solved by a ritual sacrifice of this nature or even by a real sacrifice, and quite frankly I don't view this as a real sacrifice as the profession has adopted it. The appearance problem is dominated by two factors. One, the basic fee relationship that is associated with the auditor-client relationship, and secondly, the cooperative approach to an audit which is, in my judgment, essential for both the economic and effective performance of the audit function.

To the extent that there is an appearance problem associated with consulting, that problem is in the very areas of accounting-and auditing-related skills, not in the more or less peripheral areas.

As the SEC moves to require reports on the

adequacy of internal control, as I think they should and will, the problem of appearance in the accounting and auditing areas would become even greater.

The profession's only approach, it seems to me, is to stand on its integrity and competence which I think broadly speaking has been demonstrated over the decades.

I do believe there are a number of positive steps the Board should take which I think would enhance its stature and the stature of the profession and would perhaps have a positive effect on the appearance problem.

First, I believe, it should suggest amendment of Rule 3(C) on the requirements of members to require peer reviews to include the firm's entire practice rather than simply the accounting and auditing practice.

Secondly, I think that an auditing standard should be established, and the Board should suggest this, that requires the auditor to review the work papers of any consulting engagement undertaken by his firm. In addition, consultation between audit and management services staff should be required to meet certain continuing education requirements in auditing and accounting problems, so that they will be sensitive to the implications of circumstances which they may discover in their consulting work.

These are all proposals to tie together more closely the auditing and consulting functions and thus achieve the benefits of better information that arise from them.

Finally, I suggest that the appearance problem can best be resolved by full disclosure and openness about all auditor-client relationships. An open environment reduces suspicion. Thus, I believe the Board should suggest amendment to Rule 3(G)8 of the requirements (which requires disclosure of clients)

to include total fees paid by each client broken down by audit, tax and consulting services, and further, I recommend that the Board suggest to the SEC that disclosure of all facets of the relationship between auditor and client be required in proxy materials including the processes of auditor selection, compensation and communication with the Board and its audit committee as well as fees.

I think you are aware, in general, of my views from my letter. That is a summary of them, and I will be delighted to discuss any of them with you that you are interested in discussing.

MR. McCLOY: Let me be sure I have got those three things. You are talking about the effect on the appearance problem. You would go beyond what is now required in the disclosure area, the inclusion of fees paid.

DR. BURTON: I believe that the problem of appearance to a significant extent arises from the suspicions that are engendered by a private relationship that is not disclosed.

I think this can be assisted by requiring the disclosure of this relationship. I think it is beneficial to have disclosure of the total financial relationship between the auditor and the client and that this will enhance a feeling of openness and will reduce the suspicions among those who perhaps today believe that first, there is an unholy alliance between the client and the auditor, and second, that consulting plays a major role in it, which I don't think it does, and I think that the evidence has not suggested that it does.

MR. McCLOY: What was your third?

DR. BURTON: I had the amendment of the rule to require peer reviews to cover the entire firm's practice. Second, that auditing requirements be

established which mandate the review of consulting engagements by the audit partner so that he is aware of them, and that there be continuing education requirements placed upon consulting personnel to sensitize them--

MR. McCLOY: Tie that together.

DR. BURTON: Yes, to sensitize them, and the third was the question of full disclosure which would include both the disclosure of fees to the AICPA and in the public document filed, and POB recommendations to the SEC that there be disclosure of all facets of the relationship in the proxy materials which would include the processes of auditor selection, compensation and communication with the Board and its audit committee. That is part of the disclosure.

So basically, the three suggestions I have are first, the expansion of peer review; second, tying together consulting and auditing in a more effective manner to make sure that the auditor has the use of the consulting expertise; and third, the full disclosure of the auditor-client relationship.

MR. McCLOY: Is there anything else you can think of?

DR. BURTON: No, I think those represent my thoughts, at least at the present time, on that subject.

MR. GARRETT: Keep him talking, though. Give him a little time to think. (Laughter)

To the extent that I was concerned or curious about the way in which audits would be improved and audit personnel made more competent by the presence of MAS services in a firm, in light of the semi-Chinese Wall that seemed to exist, at least in some of the more structured firms, you would suggest that rather than further separation and departmentalization, there be a direct interchange and involvement so that

MAS people would be brought right into the audit process.

DR. BURTON: I think that this is the way in which their expertise can be best used, and you have protection against what would seem to me to be a disastrous situation where the management services people would be discovering all the bad things in an area while the audit personnel were blithely moving ahead to opine on financial statements.

I think I mentioned in my letter one case where I was involved as a consultant in credit policy where our consulting engagement directly benefited the audit, and it would have been most unfortunate for the audit personnel to have been not aware of what we were doing in the credit policy area.

MR. GARRETT: There is a practical and legal hazard there.

DR. BURTON: Yes, there would be a practical and legal hazard as well as a problem in terms of the public interest, so-called.

MR. GARRETT: How does the presence of MAS stimulate or make it more exciting for students? Do they imagine themselves going with firms and at least having the opportunity to get into broader things than strict auditing?

DR. BURTON: I think it is fair to say that to the best students in graduate business schools, the term "auditing" leaves an impression which is not exactly consistent with what auditing is, but which gives a very negative reaction.

Most of the best students say that they don't want to be auditors. When they get into the firms, they often discover that auditing can be a quite creative activity, particularly where it is related to client services in a variety of ways, but they are immediately

attracted to the consulting side of the firm or to the opportunity to go into the consulting side. Some go directly, but interestingly enough, some of my best students who have originally gone directly into the consulting side wandered back into the auditing side because they have seen that as the basic product of the firm, and they have gotten interested in it. I believe there is no question that if I were identifying the very best people whom I have seen go into public accounting from Columbia, a very significant proportion of them, of the order of magnitude of certainly a third to a half, were attracted by the consulting functions which the firm performed.

MR. GARRETT: They also report, at least in some surveys that I have seen, that auditing isn't very well taught. (Laughter)

I am more sympathetic with that than it sounds because I have done some law teaching, and I know that must be the kind of operation that would be difficult to teach or make exciting while you are trying to teach it.

DR. BURTON: Auditing is an extremely difficult course to teach, and I would say that I have personally been less satisfied with auditing courses that I have taught over the years when contrasted with accounting theory and some of the other areas.

MR. GARRETT: It would somewhat like trying to train lawyers in certain procedural litigating contracts and investigations and things of that sort. It is hard to bring into the classroom.

DR. BURTON: Ultimately, I believe, the training in auditing is increasingly and appropriately being taken on by the accounting firms, that the auditing course are giving some institutional background about the profession, about ethics, about the way in which auditing standards are set, this

type of issue, but that increasingly, I think, at least the major business schools are viewing their role as not to train entry level auditors in the techniques of auditing because that is both dull and it can't be related to their experience which is the real problem that you have.

MR. McCLOY: I must just give a comment. The other day I was consulted by a young man who came to me and said, should he go into law, should he go into accounting. One of the big eight was offering him a good job, and he said, "They are telling me, gee, they are opening up a tremendous field here, and it is not only auditing. Gee whiz, they know all about the business. They can do everything in this advisory business," so I just wonder how much of this is propaganda from the schools and which is the leading factor.

I can see how the argument can well be made.

I know of another former colleague of mine who went over into one of the big accounting firms because he thought he was getting a better breadth of view in the whole business world than he was getting in the law.

DR. BURTON: Certainly than the law. (Laughter)

MR. McCLOY: I gather there is great competition for talent that goes on now. This is one of the arguments that is used.

DR. BURTON: This is true, and the accounting firms have traditionally paid somewhat less than business enterprises, but they have offered a breadth of experience, and to the very best students, they have said, "There is more to this than simply going out and ticking and checking. What you have to do is try to understand the business. You are trying to consult with business. You are trying to do many different

things," and the consulting aspect of the firm has been a major drawing card. There is no question about it. It may be public relations in part, but it is a major drawing card.

MR. GARRETT: Certainly, if you want to practice tax law, the accounting firm would be the place to go. (Laughter)

MR. McCLOY: Are you opposed to any limitation, whatever, on the scope?

DR. BURTON: I believe that the basic limitations which are in the Code of Ethics now, which deal with competence and compatibility, are working satisfactorily. I think that it would be inappropriate for accountants to serve, for example, as investment advisers. In the first place, there would be a conflict of interest and an insider information problem, and a lot of others, but even beyond that, I think it would be inappropriate, if not incompatible. That is a judgment I make; I don't think it would be compatible. On the other hand, within the consulting area where you are providing advice to the management, I see no areas where there would be a particular problem in my view, and I think that today there is not a major problem in the firms adopting reasonable positions in this regard. As I have seen consulting practice, it doesn't seem to me that there are examples or at least not many examples of services that are incompatible which are still being performed, so I am not unhappy with the system as it exists today. I wouldn't think that the accounting firm should be able to acquire a department store, and I similarly don't think that McKinsey & Company should be able to hire 25 CPAs and start an audit practice, which is perhaps a more interesting question even than the accounting firm acquiring

McKinsey, and again I think the limitation that says a majority of CPAs is a satisfactory protection against a tail-wagging-the-dog type approach.

MR. McCLOY: Do you have any difficulty at all with the actuarial issues before us?

DR. BURTON: No, I don't. I think that there is always some problem of the CPA auditing his own work. That is a problem that I think has been--

MR. McCLOY: Don't they audit their own work in a great many cases?

DR. BURTON: That is correct.

MR. McCLOY: Computers.

DR. BURTON: Again they are advising their client. If the CPA was serving simply as a black box where he was just giving the client the number and then putting it in the financial statement and then auditing it, then there is a problem, but I don't think it works that way.

I think in many cases there is this where the CPA is advising on items that are very significant to the financial statements.

MR. McCLOY: I treat that as sort of a cliché, the argument that you are reviewing your own work because it seems to me that in reviewing your own work, it is a matter of direct or indirect relationship, but in many respects, you are doing it, so per se, I don't think that is a condemnation. You have to go further with your condemnation.

DR. BURTON: I would agree.

MR. McCLOY: You don't have any problem with executive recruitment?

DR. BURTON: No, I think that my own experience with it, and as I cited, I am a director of one company that has used their accounting firm, indicates that the service was an extremely valuable one that has contributed to the quality of systems and the quality

of personnel, and thus enhanced the financial statements and the audit.

I don't see an executive recruiting problem. I think it is a natural service for the firms to perform, and I think that in general the step of professionalizing it rather than making it entirely informal has been a beneficial one, both to the clients and in terms of any potential problems. It is more than just recommending a friend now.

MR. McCLOY: Do you place any value on this principle that you should recommend six or five rather than one?

DR. BURTON: It wouldn't trouble me to see one recommended. I mean, I think that in any search process it is unlikely you will emerge with only one candidate, but I certainly would not hesitate to see a CPA firm say, "We have interviewed five candidates, and you have interviewed three, and we think this one is the best." I see no problem in that.

MR. GARRETT: I would like to add one question to that, and that is would you draw any line. Presumably, you would not, at the rank of the person being put in? Executive recruiting could extend to Vice President Finance and the Controller, or the top officer himself, without you having any problems. Some firms have said: "We stop short, if it is somebody that is key to the management decision whether to hire or fire the auditors."

DR. BURTON: No, I don't see a problem, and I have heard some people raise questions in regard to whether or not executive search should be utilized to identify potential outside directors. For the same reason, I don't personally see the problem. It does not seem to me that the evidence supports the suggestion that this will create a problem, and as I get back to the question of

appearance, the appearance is so dominated by the question of fee, if I were talking about it--those who are suspicious are going to remain suspicious, and providing them with a ritual sacrifice is not going to allay that suspicion. That is why I disagree with Mr. Klion's statement this morning which said: Well, we would like to do this and be done with it. If you do this, you are not going to be done with it. This is merely the first step because those who are suspicious, are going to remain suspicious, in fact, more so because they will see something that appears to be something that it isn't, and that will make them more suspicious rather than the other way around.

PROFESSOR CARY: I think you have covered most of the things that I had in mind, particularly that one that I addressed frequently and talked with you about such as the merger with McKinsey and what-have-you.

You did say that it bothered you to see them go into investment counseling and what-have-you, and that is the question of compatibility, as I see it.

What that means is that you are drawing some lines, and the issue is whether or not any of the lines that, for instance, have been drawn in this proposal, in the Notice, were wrong or right, or whether, in other words, when they limited themselves, in respect to plant layout, I assume that is based on the compatibility theory and justifiable, or what do you think?

DR. BURTON: It seemed to me in the first place that there was very little limitation in the proposal. But I don't believe that very specific limitations are desirable. You must look at the facts in each case. The general principle of compatibility is sufficient without drawing lines.

I have no problem, for example, with the area of contract research which was mentioned this morning. It seems to me that there is no reason why an accounting firm should not undertake a research project for the Financial Executives Institute that would deal with certain problems. I also see no problem with psychological testing within the framework of executive testing within the framework of executive search. I think this may be a useful tool.

I think there do come some questions where, if you employ an independent group of four psychologists, and you say: "This is our psychological testing department," and they are going to do just psychological tests, you raise a question, in my mind, at that point, as to whether that is compatible, but I don't see a way of drawing a line by rule because when you draw a line by rule, you have to cover 100% of the cases, and that is extremely difficult.

So my view is that it is sufficient to establish the principle of compatibility and to identify certain examples of extreme cases, and such as I practicing law or investment counseling or brokerage. I can see you explaining why certain cases are extreme, but I don't think it makes sense to come down and say: "We are now going to write a rule that explains the difference between dusk and dark," even though I can tell the difference between noon and midnight, as they say.

PROFESSOR CARY: Looking at the whole profession, you don't see any evidence that they are moving in new directions? One, are they moving in new directions; and two, if so, are they directions that one would be concerned about, if we don't have some rules, if we don't have some line?

DR. BURTON: I am not sure that they are moving in enough new directions, to tell you the truth, but I do not see any new directions that are, at the moment, dangerous to the profession.

I believe that it would be very desirable for the profession to move more in areas such as corporate directorship and areas such as education, greater continuing education activities.

There are a variety of things that I think would be beneficial both to society and to the profession.

I do not see anything on the horizon that strikes me as representing a substantial risk.

PROFESSOR CARY: The last question is, we have referred several times to this ASR-250. Mr. Gunders raised it, and it has been further developed by Mr. Klion.

You have spoken in favor of disclosure, but is this the kind of disclosure you would favor?

DR. BURTON: I think that the disclosures in 250 are not the right ones to a significant extent. I commented to the Commission endorsing the fee disclosure proposals that were originally made.

I think that it is desirable to lay out on a regular basis the full nature of the relationship between the auditor and his client. I think it is a mistake to single one out and say: "If you do consulting, then you should disclose the percentage of fee, and you should disclose whether the audit committee has approved," because that implies a criticism of the consulting practice.

I think it is far better to have as a routine disclosure of the full aspects of the relationship between the auditor and the client which includes: How is the auditor selected? How does he communicate with the board? What is the responsibility of the audit committee? What are the services he performs? And

this should be put out in the open on a regular basis rather than identified as something that is a little questionable, which is sort of what is implied in 250.

So I don't think 250 is the right approach, but I do believe in a disclosure approach.

PROFESSOR CARY: Do you think 250 is going to have some unfortunate results as might have been indicated by earlier speakers?

DR. BURTON: I believe, and I admit if I were out on the firing line, selling consulting services, I might have a different view, but I think that the effect will not be in any long-term basis very significant. I think it may this year as audit committees are particularly talking with lawyers who may be nervous and concerned beyond reasonable levels, so there may be some short-run effect, but I don't think it is going to have any significant long-term effect.

The disclosure will become routinized even in this regard, so it may be a first year effect. I don't think the long-term effect will be bad, but I don't think it is the right approach.

MR. McCLOY: But you would advocate disclosure?

DR. BURTON: I would advocate disclosure. I believe it has to do with the openness of a relationship. When you are talking about the suspicions that people have, and that is really what you are talking about when you are talking about the appearance of independence, people are suspicious because they know that the auditor is paid by his client.

MR. McCLOY: That is the main reason?

DR. BURTON: That is the main reason, so at least, lay it all out. Let it be known, and they you

say: "Yes, it's true," but then you have to educate people to the counter balancing pressures on the auditors, and they are significant.

I don't suggest any method other than having the auditor paid by his client. I think that is the best approach of any that I have heard' suggested.

MR. McCLOY: Is there any place in the world where anybody but the client pays the fee? Does the government pay the fee anywhere that you know?

What about alternatives to the client paying the fee?

DR. BURTON: I am not aware of any place where there are other approaches. There are some cases where, for instance, in the United Kingdom there is disclosure of the audit fee by all companies. That is a standard, but it is paid by the client still.

There are a couple of places, I believe, where there are certain responsibilities that government officials have to look into things, but still the basic auditor relationship is the same.

If you are looking for approaches, you could have a pool of funds administered by a stock exchange. There are other approaches, but I don't believe you should remove the economic discipline of the client-auditor relationship.

If you look at the world of medical reimbursement, you see what happens when you eliminate all economic discipline. I think the economic discipline is necessary. It is part of keeping the audit fee within reason.

MR. McCLOY: Isn't there a suggestion in this ASR-250 of some implicit disapprobation of the MAS concept? Before I came to this hearing about a week or so ago, as a lawyer I was consulted about ASR-250. There was a feeling of the client being discouraged about obtaining MAS services from the auditing firm.

So why have the risk with all this litigious atmosphere that we are in today? Why not just go and take the MAS from some other firm? And that is rather unfair, I think, in view of all the argumentation we have had here about the benefits of MAS to the audit function, you are suggesting that that implication is diminimus.

DR. BURTON: I think the first year effect may be significant, but I don't think the first year effect may be significant, but I don't think in the long run it is going to be a major problem to the firms. I do think there is implicit in ASR-250 a criticism of services which I don't believe is appropriate, so I think it is the wrong approach. Rather than create a regular disclosure vehicle for all services, it sets out something as a particular disclosure which leaves an implication of criticism.

MR. McCLOY: One other suggestion was made this morning by someone--I forget just who it was now--they were against this limitation of scope just because we were already overregulated in business. Do you think this business is being overregulated today? (Laughter) You say you are a professor of business.

DR. BURTON: I would say two things to that. One, overall, the answer was yes. But as is typical of those who are criticizing government involvement who don't think government involvement is good in areas in which they are not particularly interested but favor it in the areas they are, I think in the disclosure area, there is not overregulation.

I think disclosure is the right answer in a society such as ours. On the other hand, if you ask me about OSHA and a few of the environmental requirements, I think the cost benefit trade-offs are not recognized, and the costs are far greater than the disclosure costs.

MR. GARRETT: We all witness, with respect to companies, the tendency to equate disclosability

with impropriety.

I notice that particularly in the management perk disclosures where sometimes there they were right, but not necessarily.

I take ASR-250 as also implying that there is some significance in the relationship of the total revenues that the auditor receives from the auditing function as against all others.

Does that suggest that there ought to be some limitation, that one cannot have more than 40% - 50% relationship, or something of that kind, that you get more corrupt. You are making more money out of selling your MAS than you are out of your auditing.

DR. BURTON: I don't believe that is correct. I think in a particular year you may have a massive consulting engagement, and it may represent three times your audit fee that year.

On the other hand, on a continuing basis, it is unlikely that your consulting activity will ever be substantially greater than your audit fee. One of the protections as well as one of the risks in consulting activity is that if the auditor does a really bad job in either, he is likely to lose the other, and particularly since the audit is normally an ongoing job, audit partners are always concerned that the consultants will go in and butcher a job and it will cost them the audit relationship as well. But I don't see any need for a quantitative limit on consulting.

Again, I think in the aggregate, when you say that more than half the members of the firm must be CPAs, you are building in some protection, and that really avoids what could be a problem of consulting becoming the dominant factor.

MR. GARRETT: Some, though, we hear are hiring industrial engineers and sending them to school at night to get a CPA.

DR. BURTON: I don't think that is necessarily a bad situation. I think you could construct a hypothetical where I would say that there is probably too much consulting where the accounting and auditing expertise of a firm is no longer a key element in its economic success. I think in the final analysis there must be a recognition on the part of firms that are in the accounting area that accounting expertise has to be a key element in their economic success.

But I see those limits as so far removed from anything we have today that I don't see that as a major problem, and as I said, I think the limitation of 50% CPAs is a reasonable one because I think when you go through the training for CPA you are then sensitized to the kinds of problems CPAs must face.

MR. GARRETT: We spent some time yesterday worrying--at least I did--about certain types of advisory projects, that would cause the firm to be so involved, so concerned with the success of a project that they helped plan and recommend, that it might corrupt, however subtly their judgment with respect to recognition of defects or in the extreme case, recognition of the need to write it off.

Does that cause you any concern?

DR. BURTON: I suspect you could construct a hypothetical where there could be a problem in that situation, but I think in large part one of the big protections in such a situation is that there are countervailing forces of significant magnitude against allowing your audit judgment to be swayed by something of that sort. The existence of liabilities and the existence of the risks that you would take, if you allowed your judgment to be swayed, are such that I believe they represent a reasonable protection against this abuse.

MR. GARRETT: I suppose internally within

the firm, too, as far as that is concerned.

DR. BURTON: Yes.

MR. GARRETT: The audit partner might not be very eager to make his MAS partner look good at his expense.

DR. BURTON: I would say that the audit partner would be more worried about what would happen if he was wrong. It would not be so much a question of worrying about letting the MAS partner look good but what would happen to him if he really went too far.

MR. McCLOY: That comes up in connection with acquisitions and mergers?

DR. BURTON: It might. Acquisitions.

MR. McCLOY: Or major overhaul of the business.

DR. BURTON: There would be situations. I mean, you could construct a hypothetical.

MR. McCLOY: A tendency not to write off the mistake as early as you should have.

DR. BURTON: There is such a tendency unless you have a bad year anyway in which case you tend to write it off earlier than you should. (Laughter)

MR. STARK: Dr. Burton, yesterday Mr. Gunders of Price Waterhouse suggested that for a number of reasons, including antitrust concerns and other reasons, the profession should not impose restrictions on itself with respect to the scope of services, but he suggested that the SEC should have a role in this area. My question is whether you see a disposition or a likelihood or a pressure that might develop for the SEC to act in case the profession doesn't act on this particular issue.

DR. BURTON: There is certainly that possibility because if you are looking at a political judgment, which is really what the question is, it is possible that the SEC will make the political judgment

that they must take some action.

However, if this is to be a political judgment, I believe they are the ones who should make the political judgment and the profession should not attempt to take a position that we are going to do something not because it is right, but because we want to avoid the political judgment which the SEC might make.

In addition, if it is to be a political judgment, it is probably not bad to allow the SEC to make it and to be able to go to Capitol Hill as heroes.

I think that is in the best interest of the profession rather than to have the profession go there and say: "Here is what we did, and the SEC meekly went along." I mean if it is really a political problem and someone has to take a step, take a stand, which is not based on logic or rationality but based solely on political phenomena, I think the Commission is the better one to do it.

MR. GARRETT: There was also a suggestion of antitrust exposure.

DR. BURTON: Antitrust is an additional variable. I guess I am already on record as being concerned about this whole structure in that framework as a possible problem.

MR. McCLOY: Do you think the POB may be liable for antitrust suits?

DR. BURTON: I believe that the ability of the Oversight Board and the Section to impose effective disciplinary sanctions, which I think is an essential component in its ultimate success, is subject to question on antitrust grounds. I am not an attorney, but I have been told by various people who are attorneys that there are some legitimate questions that might come up, and if the Oversight Board ultimately is to be successful in the public eye, I think it must be seen both within the profession and outside as imposing

effective sanctions where deficient practice is discovered.

MR. McCLOY: Do you know where any legal memoranda on this reposes? Have you or the SEC collected an authority on that?

DR. BURTON: No, I would refer you to Mr. Pitt at the Commission who I understand studied this at some length, and I would not propose to practice law in this area.

MR. GARRETT: We had better hurry, do you agree, because in a couple of weeks it will be expensive?
(Laughter)

DR. BURTON: That is true.

MR. GARRETT: One other idea, putting words in Mr. Gunders' mouth. He can speak up if we misquote him, that something could be gained by further exposure and perhaps even codification or restatement of the series of interpretive advices that the staff have given with respect to prospective MAS engagement and independence.

I don't suppose you are familiar with everything that has been written or said over the 40-some years.

DR. BURTON: I have looked at a number of them in connection with SEC consideration of particular problems. I have not made a study of the totality of them.

I think that it is always worthwhile where a staff or a group is making a series of ad hoc determinations to look at them from time to time and see if there are any principles that could be enunciated as guidelines. But again, I am troubled by trying to write a rule because I think that each factual circumstance has so many variables that you have to be able to consider the variables rather than just look at one or two in each situation, so I don't think that you will get or should have a rule book,

but it may be that from time to time where advisory opinions have been given that there should be some attempt to bring together these opinions and draw some general guidance from them. I don't think it should be an official rule that is drawn from these. At least that would be my reaction.

MR. GARRETT: No, but it could be susceptible of the common law process of taking a bunch of specific cases, all of which must imply some abiding rule and trying to draw conclusions from them.

I don't know what we would find if we did it, but it would be interesting.

DR. BURTON: You might also at the same time, as well as looking at those, go to the description of practice that the various firms have and see whether there is anything. I know I have heard today a couple of firms describe their limitations, and you must have on the record a number of these things, and there might be from that also some general principles that could be drawn, but I am hesitant about writing a rule simply because I think it is very difficult to contemplate all of the situations that you might find.

MR. MANZONI: One of your recommendations led to disclosure of the relationship to accountants, including disclosure of fees.

I am not entirely clear how that would cause anyone's suspicion to be subsided at all. In fact, it seems it may raise a lot of confusion in people's minds as to why fees among different firms from different audits may vary quite a bit for reasons which wouldn't be disclosed in those documents. One firm may have very effective internal control procedures which, as I understand it, would cause the audit fees to be somewhat lower than someone who didn't.

Isn't it possible that kind of disclosure

could really create a lot more confusion than solve some problems? How do we approach that part of the problem?

DR. BURTON: It seems to me that if there are dramatic differences in fees that there are legitimate questions to be asked from varying viewpoints, both from the viewpoint of whether or not an economical audit is being performed, and secondly, from the viewpoint of whether this says anything significant about the differences between firms. It may well be that under some circumstances there will be some additional disclosure if the firm feels its audit fee need requires explanation, but I think that in the first place, I am a believer that there are effective countervailing forces that exist today against deficient audits, and that it is appropriate that there be improved information that will allow the economic system to work in a competitive way on maintaining some control over the cost of audits as well, and I think that this would have some benefits in this respect.

I think if you allow concern over the possible confusion that might arise to dominate your decision as to what will be disclosed, you won't ever disclose anything because there is always the possibility of confusion.

I guess I feel that on balance there would be a benefit to having this relationship an entirely open one and a disclosed one. Not that you could not point to some potential problems, but I think I would solve those problems by more disclosure rather than by eliminating this disclosure.

MR. MANZONI: Do you go so far as to reach other suspicions related to joining the same clubs and playing golf every Saturday and having been a college roommate and a lot of other things like that.

Where does it all lead to?

DR. BURTON: I think the suspicions are more in terms of the economic relationships. That seems to me, as I have heard discussed, the greater suspicion. There are, of course, some who view the whole world as a conspiracy and those people will not be assuaged by anything, but I believe that the disclosure of economic relationships would go to what I think has been the most significant concern. I am not suggesting that it would solve the concern, but it might reduce one source of suspicion. I think it is an on balance thing. It would contribute to the openness of the relationship and the perceived openness of the relationship.

I think that there is always the danger of greater suspicion in situations that are not disclosed. So I think on balance it would be beneficial.

I don't think it would fully solve the problem because you can't solve the problem of those who are fundamentally suspicious. In the final analysis they will remain suspicious, but you take a step, and that is the kind of step, I think, should be taken if this Board wants to do something. The proposal of the Section is, on the other hand, a step that says: We will appear to eliminate some limited number of services, and thus show our good will. I just don't think that makes sense at all.

MR. McCLOY: We have heard a good bit about ripple effect. I am sitting here as a lawyer. Are you going to "ripple" over the legal profession and make them disclose their fees? I shudder at the thought.

MR. GARRETT: Well, you do if you are on the Board.

DR. BURTON: I am a believer in general disclosure, and I would not exempt the legal profession although they write the laws and thus have generally been able to exempt themselves from many of them.

(Laughter)

MR. GARRETT: But they also manifest great self-restraint in limiting their behavior to strictly legal matters.

We hear a lot about suspicion, and it always puzzles me that the surveys are not too compelling. I know a couple of people in Washington that displayed a good deal of suspicion, but most of them don't impress me with the factual experienced background upon which it is based.

Do you in teaching or otherwise get the feeling that there really is an image problem with the accounting profession as a whole, particularly with respect to publicly owned companies?

DR. BURTON: I don't believe that scope of services is seen as a major problem. I mean, if you send people a questionnaire, and you ask: Is there a greater problem when people do consulting services than not? And you simply ask that question without exploring costs and benefits, there is an inclination to answer yes. More business, more problem. But I don't think there is any widely held concern. There are certainly a few individuals, some of whom are forceful and articulate, who expressed this, and then there are some who have basic suspicions about how the whole system works, and this is merely one of the manifestations of that, but I don't think it is a major problem of broad public perception. I think it pales to insignificance when compared with the fee question which is the major problem, and which I think can't be adequately resolved. I think there has been more attention given to it than perhaps it warrants in the terms of how public perception exists.

MR. GARRETT: Thank you very much. It was very kind of you to come and we appreciate it.

DR. BURTON: It was my pleasure. Thank you

for listening.

MR. GARRETT: We shall now reconvene at 1:45.

(The hearing recessed at 12:30 o'clock.)

FRIDAY AFTERNOON SESSION

AUGUST 18, 1978

The hearing reconvened at 1:55 o'clock with Mr. Garrett presiding.

MR. GARRETT: Mr. Varley, is it agreeable with you to proceed? We have got the two cancellations. Mr. Frechtman is not here yet, so you are the next in line.

MR. CARL J. VARLEY: I am Carl Varley with Clifton, Gunderson & Company. We have about 20 offices spread between Ohio and Colorado. The clientele is mostly small businesses. I think I could count on my hands or my fingers and toes the numbers we have with sales volume in excess of ten million dollars.

My comments today are going to be based on three what I consider factual statements, and they are: one, the small businessman has a very limited number of advisers upon which he will rely.

Two, the primary service, which we as Clifton, Gunderson are selling, is not auditing but is general advice.

Three, for us to remain competitive, we have to be in both sections of the AICPA.

I would like to get into this a little bit further. My best partners are the ones who have an advisory relationship with their clients. They are not the ones who are the best auditors. It's the ones whom the clients will listen to, the ones whom the clients come to for advice, basically a confidant relationship.

Our advice as partners to these clients covers a multitude of areas and that will include employee recruiting, plant layout and in some cases a bit of marketing advice.

Normally, they do this, I would say, on a fairly informal basis, but it still comes under the category of providing MAS services.

For an example, we are currently looking for three second-line managers for what to us is a fairly large retailer client. The owner has a very unique personality which is typical for many of our clients. We are in a position to know this client, and also to know how he is able to get along with people. I think we can provide a very valuable service in finding some one or two or three which we can propose to him that we feel have a chance of surviving, and I mean that literally.

We also spend a great deal of our time working with our clients on conflicts within their management or within the owners, between the owners.

Currently, we have a client which is 50-50 owned by two individuals. One fellow currently feels he is doing all the work, and the other guy has benefited from it, so again, we are providing advisory service for a client for which we are doing an audit. Again some people might say this would taint our independence.

Another example is we are working on two engagements where we are helping a client improve his productivity and his manufacturing process, and this will be through revising plant layouts to a certain extent. Again it is rather general and not an in-depth study, but I think it does fit under the plant layout category.

In the marketing area, we provide ideas to clients where we feel something needs to be done. One of the main items here is trying to help the client improve his visibility.

We have many clients where it is amazing how they expect business to come to them when they really make no effort to show the public that they are open and available for business.

And finally, we assist many of our clients in negotiations of buying and selling, labor negotiations and that sort of thing.

So the question is: Why do we, Clifton, Gunderson, need to provide the service? Why not someone else?

I think we have gained the respect of these clients. They respect us as advisers, plus, and very important, we understand the financial implications of the activities and of the advice we provide.

The question comes up, does this hurt our independence? I don't think so because none of our clients are large enough that we want to stake our reputation with banks which are the primary reader of our financial statements. We don't want to stake our reputation with banks which are the primary reader of our financial statements. We don't want to risk our reputation with banks and to a certain extent bonding companies.

Finally, our audits are better because of this knowledge we have of the client. We know things about the client including his personal marital problems that I am sure does not occur with much larger firms.

So in concluding, I would like to say that if we don't provide this broad business advice, our services become much less marketable. If all we are doing is providing an audit, then I think it should be basically the low bid gets the job, but by providing these additional services we understand the client much better and do a better job at the audit.

Secondly, if we don't provide broad business advice, our clients will be losing a very valuable service and I say it is very valuable because they seem to be eager to pay our fee. It is not a problem that they don't think they are getting their money's worth, and finally, it would seem to me, a personal opinion that regulation is getting somewhat out of hand, that we seem to be going around trying to find someone to protect, and this is creating a lot of time being spent and a lot of

dollars being spent when basically, I guess, we are assuming that the public is not too intelligent.

Believe me, as far as our clients and the people that read our reports, I have found them to be quite intelligent.

Thank you.

MR. GARRETT: Thank you. How large do you say the profession staff is of your firm?

MR. VARLEY: We have approximately 250 personnel, yes.

MR. GARRETT: And you have a separate MAS department?

MR. VARLEY: Yes, there are five of us in it.

MR. GARRETT: Five. Is most of the advice that you are talking about from MAS?

MR. VARLEY: Absolutely not.

MR. GARRETT: Or day-to-day consulting that we were talking about this morning?

MR. VARLEY: It is day-to-day consulting, yes, sir.

MR. GARRETT: And you sometimes help the partner that gets the call, I suppose.

MR. VARLEY: That is right.

MR. GARRETT: Do you also have separate engagements.

MR. VARLEY: Yes, sir.

MR. GARRETT: That are from your department?

MR. VARLEY: Definitely.

MR. McCLOY: Your recruiting has been in the lower range of the accounting-financial areas?

MR. VARLEY: Not necessarily.

MR. McCLOY: Have you recruited CEOs?

MR. VARLEY: No, it is the owner that is hiring us, so he is not looking for his replacement.

MR. WOOD: Do you recruit a chief financial officer?

MR. VARLEY: In many cases that will be a

bookkeeper, but yes, we will recruit a controller.

MR. WOOD: How many states or cities do you operate?

MR. VARLEY: We have 20 offices between Colorado and Ohio.

MR. GARRETT: But your typical client, if not every one of your clients, needs an audit only for bank purposes or--

MR. VARLEY: Yes.

MR. GARRETT: --there may be some members of the family that are not active in management who want it, and that sort of thing.

MR. VARLEY: Right, a group of doctors feel better if they have had an audit.

MR. GARRETT: But they are not investors in the ordinary sense?

MR. VARLEY: No.

MR. GARRETT: If the Executive Committee proposals were to become the rule, would it force you to curtail a significant amount of the services that you render, do you believe?

MR. VARLEY: Not as I understand they are stated because we have, I think, one SEC client, and that was the result of a recent merger.

MR. GARRETT: But even there, do you think you go beyond what they would condone or say was all right?

MR. VARLEY: I think if you took it literally, I have partners and myself giving advice to clients which would violate.

MR. GARRETT: Would they be management decisions or not auditing-skill related?

MR. VARLEY: Not auditing-skill related.

MR. GARRETT: I see. I don't suppose you can be sure unless you fall within one of their express

examples because one of our problems is that we are not sure either just where the audit-skill related stops.

MR. VARLEY: Right.

MR. WOOD: Are your five MAS people also accountants?

MR. VARLEY: Three of us are, but one is also a Ph.D. with civil engineering, so it is kind of a shared profession in this case. Two are not.

MR. GARRETT: So it would be, I suppose, as a practical matter, satisfactory for your firm if a distinction were made between the SEC Practice Section-- no, it wouldn't since your members of the Section, I presume, or you wouldn't be here.

MR. VARLEY: Yes, and we feel we must remain that way to be competitive.

MR. GARRETT: But there could be a distinction with respect to services provided to non-SEC clients.

MR. VARLEY: If it would hold, right, but I assume that eventually it would filter down and become for non-SEC also, the restrictions.

MR. GARRETT: If it is theoretically based on independence, I suppose it would have to, wouldn't it?

MR. VARLEY: Yes.

MR. GARRETT: Since you can't make that distinction.

MR. MANZONI: Which services do you provide now that you think may not satisfy the skill-related criterion?

MR. VARLEY: The recruiting, plant layout, marketing.

MR. MANZONI: It is hard to tell when they do and don't, but those are the ones you think of.

MR. VARLEY: Yes, those are the ones that I would be concerned. The others I don't feel that we will ever get involved with, with our clientele.

MR. GARRETT: This plant layout is for production purposes, and not for paper flow and information flow purposes?

MR. VARLEY: Right.

MR. McCLOY: It is for production purposes?

MR. VARLEY: Yes, sir. Not initial layout, but many of our clients kind of start out in a garage, and start throwing in pieces of equipment, and then eventually as they grow, it gets pretty obvious that something has to be done, so we may, in fact, say: "Why don't you shift things around a bit?"

MR. GARRETT: Is that the larger part of your revenues from MAS Generally?

MR. VARLEY: When you say that, what do you mean?

MR. GARRETT: Is the larger part of the firm's revenues from nonauditing services, or can you tell, so much of this is on a day-to-day consulting basis?

MR. VARLEY: I don't think we can really tell in all honesty. So much of our fees are billed accounting services, and yet it is the partner advising the client on some decisions the client has to make.

PROFESSOR CARY: You don't bill separately for an audit?

MR. VARLEY: Not necessarily. In some cases, yes, but not always.

PROFESSOR CARY: A period basis, I see.

MR. WOOD: Are the pension plans of your clients governed by ERISA?

MR. VARLEY: Yes.

MR. WOOD: And do they use outside actuaries?

MR. VARLEY: Yes.

MR. WOOD: Do you audit the unfunded pension liability? How far do you go to take a look at their findings?

MR. VARLEY: Now you are getting out of my area of the practice definitely, but to the extent of

my knowledge, we have on occasion asked the client, and most of these are insurance company plans, to have an independent actuary look at it also because we weren't quite sure if the insurance company's information was correct.

MR. WOOD: And you would accept the findings of the retained actuary then in that case?

MR. VARLEY: Yes, if they agreed with the insurance company. If we have the two, then definitely. If there is a conflict, then we may have to go further.

MR. GARRETT: You used an interesting argument as to why there is no impairment of independence. You have so many little clients. I am not saying this in any scornful way. I can understand it very well, I am sure, the lack of any client on which you are beholden or that is terribly important to your total revenues is a corrupting possibility.

MR. VARLEY: True, and I think I have seen examples where I have felt some firms had a major client that it had to be a consideration for them at least, but in our case, it has not happened.

MR. GARRETT: I think that is all.

MR. McCLOY: I don't have any.

PROFESSOR CARY: No questions.

MR. GARRETT: Thank you very much, Mr. Varley.
Now Mr. Frechtman. Please proceed.

MR. A. BERNARD FRECHTMAN: Thank you very much. Among all of the professional accountants, I feel a little like a fish out of water. I may be the only lawyer about.

I am A. Bernard Frechtman, general counsel to Robert Half Personnel Agencies. Its President, Robert Half, wanted to be present here today, but because of a previous out-of-town commitment he is unavailable. He does, however, feel that the work of this committee is very important and designated me to convey his views to you. On his behalf, I want to express my appreciation for your permitting me to attend and as well your accommodating to my own legal commitments.

The responsibility of certified public accounting firms for avoiding conflict of interest problems was well set forth in a report issued by the Accountant's International Study Group entitled "Independence of Auditors" in which it was stated:

"The concept of the auditor's independence cannot be precisely defined because it is considered a state of mind and character. Independence is viewed from two perspectives-- independence in fact and independence in appearance. Independence in fact refers to the quality of not being influenced by regard to personal advantage. Independence in appearance refers to the absence of certain ascertainable circumstances that give rise to a potential loss of independence or conflict of interest, which may lead third parties to conclude that the specified relationship poses an unacceptable threat to the auditor's independence."

Personnel selection is the most important of all management functions and the manner in which it is carried out largely determines whether there is independence in fact as well as independence in appearance.

It is the function furthest removed from the auditing responsibility and is the clearest case of

present and potential conflict of interest.

As long as certified public accounting firms participate, even slightly, in the selection of personnel, either by direct recruiting or by staff transfers, they do in fact become part of the management of the clients they audit or eventually may come to audit.

It is simple to understand the conflict as it comes from the situation that exists when a certified public accounting firm acts as an employment agency in recruiting personnel either on behalf of a client or on behalf of a company that in the future may potentially become its client. In both instances a subtle relationship of allegiance arises between the newly placed employee and the certified public accounting firm acting as an employment agency which found that employee the job and the employee's expectation that future jobs are similarly available. A thread now exists between the employee and the certified public accounting firm acting as an employment agency, that if undisturbed by future action can be strengthened to provide for the growth of the employee's own professional future.

But an even more insidious practice, which is not so easily discernible is that of certified public accounting firms, whether or not acting as employment agencies, in making transfers of their own staff to the staff of a client where they often assume a key position. If that staff member owes the job to the certified public accounting firm, it is clearly impossible to maintain either an actual independence or the appearance of independence as the Accountant's International Study Group said. In fact, this establishment of an alumni placement bureau is a form of patronage that gives an employee a total feeling of security that the employee is highly unlikely to

disturb.

But the faith of the employee in making his future progress in this way is falsely placed. In fact, were the certified public accounting firms prohibited from acting as employment agencies, employees would have an expanded opportunity for upgrading their positions and employers would likewise be able to find competent personnel more easily. As things now stand, a certified public accounting firm will rarely recommend that a client hire staff personnel from another certified public accounting firm. Its prime motive in transferring staff is to assure that the client company is populated with as many people as possible who own strong allegiance to the former certified public accounting employer while simultaneously providing itself with an easy egress for its unpromotable employees thus making room for recruiting young fledglings. Since all large accounting firms share this philosophy, it places severe restrictions on the staff person who relies on the accounting firm to secure an accounting position outside the public accounting profession. Each placement made by a certified public accounting firm helps perpetuate the cozy relationship that exists between the auditor and the client. The net result is a drastic reduction in objectivity.

If you intend to eliminate questions concerning the credibility and integrity of the independence of a certified public accounting firm's audit, whether those questions deal with reality or appearance, you must mandate a complete elimination of the involvement of certified public accounting firms in the employment process. Only in that way can we be sure that the certified public accounting firm and its clients, and vice versa, are completely free of influence. Without this complete separation there will always be a subtle question of the

integrity and independence of the audit.

If certified public accountants continue to be permitted to recruit key employees for non-clients, they will end up with strong loyalties as those employees may likely go out of their way to bring the account to that certified public accounting firm. Then we are back to the conflict of interest. Now that the professions are permitted to advertise, aggressive certified public accounting firms will promote their recruiting service by direct mail and newspapers and magazines since they can afford massive advertising campaigns. They will in this way obtain non-audit clients for this recruiting service frequently ending up with them as audit clients and thus causing a further concentration of large client audits. In other words, non-auditing services advertised by big money will ultimately force the small and medium-sized firms to lose clients.

Mr. Chairman, somewhere out there is a fraud "incubating" as a result of some quasi-relationship established between a certified public accounting firm and the placement of an employee at a client which is the subject of an audit by that very same firm. Attorneys now armed with facts relating to these kinds of personnel activities could be involved in some sort of litigation resulting from an outgrowth of that relationship. Of course, there is no proof that anything adverse has happened as a result of the conflict of interest I have just described. In the cases of proven fraud, there is no necessity of showing this conflict of interest. The fraudulent act is generally sufficient. On the other hand, the appearance of the conflict of interest may give rise to a further basis for predicated appropriate litigation given the proper circumstances.

I urge you to stop it now before there will be an embarrassment to the entire accounting profession as a result of the charge that in fact there exists outright collusion between an accounting firm and employees of its clients. I urge you as well to consider that the only way you can regulate the "state of mind and character" of an auditor's independence to assure that the opportunity to put a blemish on it is to prohibit the possibility of its occurrence by barring both recruiting and staff transfer.

MR. GARRETT: Have we any questions?

PROFESSOR CARY: May I ask, your firm has no accountants and it is primarily a personnel firm, or am I clear?

MR. FRECHTMAN: My firm is a law firm.

PROFESSOR CARY: The firm which you are representing.

MR. FRECHTMAN: The firm which I represent is only in the personnel business.

PROFESSOR CARY: No CPAs?

MR. FRECHTMAN: The only CPA in the firm is Bob Half who is a CPA, who is not engaged in the practice of accounting by your own rules that prohibit him from doing so.

There are, however, among the franchisees who operate Robert Half Personnel Agencies throughout the country, Canada and Europe, some people who are CPAs, but likewise, they do not practice.

PROFESSOR CARY: They specialize primarily in persons having a financial and accounting background?

MR. FRECHTMAN: Exactly. That is their entire expertise. They have been doing it for about 30 years now.

MR. WOOD: So a generalist would not be recruited by the Half Agencies?

MR. FRECHTMAN: By generalist you mean?

MR. WOOD: Marketing.

MR. FRECHTMAN: Yes, marketing, sales people such as that. They would only deal with accountants, controllers, financial people, EDP, financial vice presidents, bookkeepers, and so forth.

PROFESSOR CARY: I just wanted to ask, you made the point that accounting firms will seldom recommend staff from their competitors, and yet I suppose they might seldom recommend a staff member from their own firm if they think the person is particularly good and perhaps of partnership caliber. Isn't that right?

MR. FRECHTMAN: If they are partnership caliber, it is not likely they are going to recommend them. If they are not partnership caliber, and there is no place for them to go within the firm, and while they may be otherwise competent and capable, it is very likely that they would recommend them as a staff transfer. It happens in law firms as well, except law firms are not engaged in any kind of executive recruiting activity, and they don't audit their clients.

PROFESSOR CARY: I understand the parallel.

MR. WOOD: Would you see the same possibility of compromised relationships if the CPA firm recruited an assistant controller for its clients, its audit client, from another auditing firm?

MR. FRECHTMAN: Yes, I think that the subtle relationship that exists is the one that says that that employee in some way being recruited by the CPA firm, the CPA firm has exercised an influence in judgment in the selection process and subtly could likewise influence the future of promotability of that particular employee.

MR. WOOD: It seems to me that you are assuming that the management of the employer is

deferring its judgment in his capacity to its CPA firm. You are downgrading the competence of the personnel department and the officer to whom the assistant controller reports.

MR. FRECHTMAN: I don't think so. I think that they probably run parallel tracks. I don't think there are some subtle judgments that are made and there are very subtle relationships that exist. Whether or not they are real in all instances, they are certainly real in their appearance of being in conflict.

If the personnel department in the company, and we are dealing with both large and small companies, so personnel departments as a fact may be one person or may be one of the managers of the company, the personnel department makes a judgment about an employee, a potential employee, and then says: "But I want my CPA firm to interview them." then the final judgment may very well be made right there rather than in the company. They may just want your concurrence, but the applicant doesn't know that, totally.

MR. WOOD: Would you object to the CPA firm helping management to define the type of person that is needed, the scope of the job, what to look for, and then turning over the recruiting to the chief executive or to his personnel firm?

MR. FRECHTMAN: My impression is that there should be no objection to that. I may not be as qualified as Bob Half is to answer that question, but I couldn't see any objection to it personally.

MR. GARRETT: The objection that you see in the practice, is that based primarily on the fact that, in fact, perhaps if not in form, the auditing firm makes the hiring decision or is to some sort of lingering feeling of gratitude and closeness and dependence?

MR. FRECHTMAN: In which instance are you

referring to, because there are a couple. One is where they are making the referral, where they do the recruitment and make the referral and make the suggestion or recommendation, and the other instance is where it comes the other way, and they are asked to confirm the judgment of the company, and the third instance is there they make the suggestion of one of the firm's own employees.

In all instances I would suggest that the choice, the referral and the judgment is clouded by either the real or apparent conflict that is not clear, that there is this thread that is maintained between the CPA firm and that particular employee.

MR. GARRETT: Who is that bad for?

MR. FRECHTMAN: The public. In the ultimate it is bad for the public.

MR. GARRETT: Because?

MR. FRECHTMAN: Because we are dealing with conflict of interest both in fact and appearance. I mean, we both have to deal with problems in terms of ethics, and when I say "both," I mean as accountants and as lawyers.

We have to stay very clearly away from both, in fact conflicts of interests as well as appearance of conflicts of interest.

Many times we make judgments in our firm, small that it may be, not to engage in a particular matter and not to represent a particular client or not to do a particular thing because although we know that it is not a conflict of interest, we also know that it might seem to be one.

If we are now judging the integrity of what you are concerned with and what you are focusing on, which is the audit process, which the public has to rely upon, which is what your concern is, then it would seem to me that you would want to maintain

as much of a sacred circumstance surrounding all of the internal procedures that go on in doing the audit as well as all of those who are participating in doing the audit, and the relationships between those who are doing the actual work of recruiting and those who are doing the audit. So in the ultimate, it seem to me, it is the public.

MR. GARRETT: So in your view the problem wouldn't be cured if this were a casual activity on the part of the CPA firm rather than a well organized, active, personnel placement bureau, so to speak?

MR. FRECHTMAN: Not at all. I think that you ought to be totally prohibited from engaging in the practice.

MR. GARRETT: Any involvement at all.

MR. FRECHTMAN: Directly or indirectly. If you are going to do the audit, then you ought to be prohibited from being engaged in the recruiting activity.

I am not suggesting there is anything totally illegal in what is is that is going on. I am talking about the fact that there is an appearance of the possibility of compromise as it relates between the individual who has been placed by the firm that is doing the audit or there is also the possibility, as I suggested, that could incubate as a result of it. Somebody passes over something more casually because of the relationship.

MR. GARRETT: I think I understand your point.

MR. McCLOY: Wouldn't it be very unnatural, though, to proscribe any contact between the client and the accountant? Suppose he called up and said: "I have got an open spot. Have you got any ideas for an assistant controller," or "Can you give us some help." or "What do you hear in the trade about X?" He doesn't charge any fee for it. Does he just say,

"I am sorry. I can't talk to you about that."

MR. FRECHTMAN: A lot of times we tell our clients that we are very sorry, but we are prohibited by the Canons of Ethics from dealing with a particular matter, and if you are prohibited, then there are other sources to which the client can go in order to verify the information.

MR. McCLOY: It seems rather unnatural, though, to say that he can't express an opinion in regard to a matter.

MR. WOOD: Taking Mr. McCloy's question one step further, suppose that Robert Half Associates had recruited a controller, and Mr. McCloy as chief financial officer of this company calls up his CPA and says, "I would like to have you interview this fine young man that Robert Half has brought to me. Check him out. Ask him a lot of questions. Give me your judgment on his qualifications, his record." Would you object to that?

MR. FRECHTMAN: Are you talking about now making a judgment predicated upon his qualification?

MR. WOOD: You bet.

MR. FRECHTMAN: If the company is otherwise unable to do so.

MR. WOOD: Wouldn't it be logical if Mr. McCloy's XYZ Company is hiring an assistant controller, and you recommended three candidates, and after he and his personnel man have interviewed them, to ask Arthur Andersen or whoever it is that audits his company to conduct their own interview and analysis of his background?

MR. FRECHTMAN: I would think that if Mr. McCloy was going to make a judgment as to the qualifications of the individual, that that could be done with a degree of independence, but when he makes reference to, just to use your observation before, when you are dealing

with a thing that is being unnatural, in that you have a problem in turning down a client with respect to making certain kinds of judgments, that is casual, I think that that creates a problem. But if you are going to test the qualifications of an individual and you are not otherwise engaged in this kind of an activity, I don't really see that as a problem.

It is a very fine line we draw. It is when you start going over the line that I think you create a problem.

MR. MANZONI: Are there other personnel agencies besides yourself that specialize in these types of placements, financial and control people?

MR. FRECHTMAN: Yes, there are.

MR. MANZONI: Are there a large number of non-accounting firms who are doing it?

MR. FRECHTMAN: On, yes, there are a lot of independent companies throughout the United States.

MR. MANZONI: But with this kind of expertise?

MR. FRECHTMAN: I think that Bob Half would like to suggest that he has the most expertise. His people probably do, and they are probably the largest organization of its kind, probably in the world, in terms of financial placements and temporary personnel in the same area. But there are executive level agencies, personnel agencies throughout the country, from locality to locality that can among other things provide expert guidance and recruitment in this area.

You would not be without sources of finding personnel if you eliminated yourselves from the business of being in the recruitment of this kind of personnel.

MR. MATUSIAK: You are suggesting then that if the CPA firm decides to discontinue the services of employment to employees, that they just merely hand him his pink slip and say, "Sorry, you are on your own?"

MR. FRECHTMAN: That sounds very brutal,

doesn't it? But the fact of the matter is that there are all kinds of out-placement activities that take place in large and small corporations and law firms and can likewise take place in accounting firms as well.

MR. MATUSIAK: Then if I understand your recommendation, that the CPA firm would be prohibited from rendering any kind of assistance to an employee that was discharged.

MR. FRECHTMAN: I don't think that we are talking about the employee that is being discharged. The employee that the CPA firm discharges isn't necessarily sent to a client. It is the employee that they transfer to the client who is an employee who doesn't make partner in the firm.

MR. MATUSIAK: You make that sound as though it is solely the decision of the CPA firm and not the prospective client.

MR. FRECHTMAN: No, it is never solely the decision of the CPA firm. What I am suggesting is that the participation of the CPA firm in making a decision creates what I consider to be a conflict of interest. At least, if not in fact, in appearance.

MR. MATUSIAK: But you would suggest that a CPA firm be not allowed to render any assistance to a departing employee in finding a new job?

MR. FRECHTMAN: No, I never said that. They could send him to a personnel agency.

MR. MATUSIAK: Preferably to a Robert Half Personnel Agency?

MR. FRECHTMAN: Not preferably, but if they wanted to get to the best, I suppose that is the place to go.

MR. MATUSIAK: That is not giving him any assistance.

MR. FRECHTMAN: Oh, it is. What does the company do when they discharge an employee? They

engage in a lot of other activities. You are transposing something. I am suggesting to you not to focus on the undesirable employee in the CPA firm because that person is somebody you probably would not want to have transferred to a company client. We are not talking about that individual. We are talking about the individual who achieves a particular level within the CPA firm and then can go no further. The CPA firm wants to make room for its own growth. They suggest therefore some kind of lateral transfer to a client where the individual would be competent and capable of doing whatever it was that they would have him do.

MR. McCLOY: Might not the accounting firm be better equipped to supply a vacancy than your firm would just be reason of the fact that they have had this contact with the company? They know something about the company. They know more about the company than de novo calling on you who have had no relationship with the company before that. We have heard a great deal about the benefits, this morning, to the audit function that was involved, but there are some benefits it may be argued also to the company as a result of the accountant's wide knowledge due to the accountancy relationship. You discount that?

MR. FRECHTMAN: No, I don't discount it. I think I am suggesting you have to forego it.

MR. McCLOY: Because of the potential conflict of interest.

MR. FRECHTMAN: Exactly. I think you have to make a very firm decision that says essentially what is and what isn't a conflict of interest. If you do make a judgment that it constitutes a conflict of interest, then you must make a judgment that you forego that kind of activity in business.

When you really cut it down, what you are really talking about is a balance between maintaining

a professional standard and accommodating a professional standard to an economic interest of a firm engaging in another business.

There is no question but that the personnel recruiter, the executive recruiter or the personnel agency, all those firms that are out there engaged in this on a highly specialized basis can become just as proficient and just as familiar perhaps with some more objectivity with the activities of a company so as to make judgments in the personnel area. After all, if the CPA firm is engaging in this practice they must, of necessity, establish people who are no longer engaged in the audit or accounting process, but engaged solely in personnel functions, so what you really boil it down to is: Who operates the employment agency? If you want to operate the employment agency, then you operate the employment agency, and then you run the risk of what I am suggesting to you may very well be a severe conflict of interest, and it leads to some question of the integrity of that independent audit and the relationship. Why else hold on to the stake?

MR. GARRETT: Thank you very much.

MR. FRECHTMAN: Thank you very much for inviting me. You were very gracious.

MR. GARRETT: Howard I. Bernstein.

Mr. Bernstein is from Chicago. Have you any idea where to reach him, Lou.

MR. WOOD: Try the telephone.

MR. McCLOY: While we are waiting for the telephone, does anybody from the audience have suggestions or additions they want to make to the testimony they have made or comment on anybody else's testimony?

MR. WOOD: It is a rare opportunity, gentlemen.

MR. RAYMOND J. LEISNER: My name is Raymond J. Leisner. I am a CPA, a self-practitioner, and I limit my practice to management advisory services. I have spent all, or most all of my professional career in MAS, previously as a partner in one of the large firms.

I would like to address myself to two observations. I have sat through these hearings yesterday and today. One is the so-called fall-out issue of the prohibition of major firms in MAS or restriction of their practice which would cause a diminution in their total effort.

We have heard about the impact on their practice. The impact on the profession as a whole, could be substantial in that most of the technical resources of training, continued professional education, committee work, papers, et cetera which Mr. Mitchell and his group administer and coordinate, it has been my observation emanate from these larger firms out of sheer size, and accordingly, I would think that the smaller practitioners who are seeking to upgrade their skills in an ever-expanding way would be adversely affected.

I happen to work with small practitioners and serve them in their consulting practice and with my years of experience, I have no personal need for such training, but part of my job is the helping in the development of their staff, many of whom are accountants, CPAs to be or in some cases partners in these firms who are skilled in auditing and who seek through these professional courses to expand those skills. I have seen nowhere in the literature or the comments on this issue this question of what would it do to our total professional capacity of the AICPA and our state societies to meet the continued professional education requirements of

our profession if we had this kind of diminution, and I would suggest that that be incorporated somewhere in the analysis you are going to make.

My second point would run to the question of perceived problems of independence versus real. We have seen repeatedly this reference to the Cohen Commission Report, that we really couldn't find any problems, but there must be one because somebody said there was.

I can remember when this issue first came up in the mid-'50s, and we have been at it for twenty years, and I would like to underscore that I believe the profession should take a stand on the real issues and not be precipitated into something because, after all, we have some perceived government regulation which is based on this.

As others have said before, this is the time to look at the issues and say: This is for real, and let's close it out one way or the other through some action which you gentlemen would recommend hopefully.

That is really all I have to say, and I couldn't resist the opportunity for these ad lib remarks. They were not as well prepared as the others that have been here.

MR. GARRETT: You came across very well.
Thank you.

MR. LEISNER: Thank you.

MR. WOOD: I gather, Mr. Leisner, that you don't in 20 years of practice see any real compromise of independence from the MAS practice.

MR. LEISNER: No, Mr. Wood, as a matter of fact, I believe that the degree of independence that a consultant must have every day in dealing with the politics of internal management is a much higher degree of independence, or at least, as great in reality as

what his audit brethren must practice, so independence is a very important criterion of the consulting practice.

MR. WOOD: However, doesn't a consulting practice compromise the independence of the audit partner of the same firm?

MR. LEISNER: I have never seen any evidence of that. In fact, we bend over backwards generally to be sure that we are as some one said like Caesar's wife in this regard.

MR. WOOD: And it is your hope that out of these hearings and our recommendations to the Section that there will be a pretty decisive answer rendered on what you can and cannot do in the MAS area?

MR. LEISNER: Yes, sir, I do. I believe that every accused has a right to a due process, as was mentioned, which means a definitive opinion, and I believe that an examination of the facts should be able to put this in perspective.

MR. WOOD: Thank you.

MR. McCLOY: To your knowledge, has there been any sort of hearing such as this in the last 20 years on this subject, or has it just been discussed in the periodicals?

MR. LEISNER: I remember addressing comments in the 1950s on what I called the independence of ignorance which it was alleged because you knew so much about a client, it would impede your independence, whereas, it goes the other way. At that time it was mostly in the academic journals, but I can think of going back to the mid-'50s.

MR. WOOD: Has anyone seriously recommended that clients be required to change their auditing firm at regular intervals? Do any of you know whether this has ever been advanced by anybody in government?

MR. GARRETT: The Metcalf Report recommended

that.

MR. WOOD: That is what I thought.

MR. MITCHELL: I think Ralph Nader has, too.

MR. WOOD: That doesn't surprise me.

MR. McCLOY: Mr. Gilbert has, too, and Wilma Sauss. And Evelyn.

MR. GARRETT: The Metcalf Report did more things than that.

I think we will break for ten minutes.

(A short recess was taken.)

MR. GARRETT: Gentlemen, may we come to order. Mr. Bernstein, will you proceed, please.

MR. HOWARD I. BERNSTEIN: Yes, I represent several firms. I am not speaking on my own. I would like to tell you the firms that I am representing. Each of the following firms has consented to the association of its name with these comments:

Bansley & Kiener
300 West Washington Street
Chicago, Illinois 60606

Bernstein and Bank, Ltd.
6200 North Hiawatha Avenue
Chicago, Illinois 60646

Blackman, Kallick & Company
180 North LaSalle Street
Chicago, Illinois 60601

Checkers, Simon & Rosner
33 North LaSalle Street
Chicago, Illinois 60602

Clifton, Gunderson & Co.
900 Commercial National Bank
Peoria, Illinois 61602

Doty, Jarrow & Company
20 North Wacker Drive
Chicago, Illinois

Friedman, Eisenstein, Raemer &
Schwartz
233 North Michigan Avenue
Chicago, Illinois

Gale, Takahashi & Channon
120 South LaSalle
Chicago, Illinois

Goldberg, Geiser & Company, Ltd.
20 North Wacker Drive
Chicago, Illinois

Thomas W. Havey & Company
105 West Adams Street
Chicago, Illinois

B. L. Rosenberg & Company
Suite 2300
180 North LaSalle
Chicago, Illinois.. 60601

This statement represents the collective opinions of eleven local Illinois CPA firms employing over 607 partners and staff and billing about \$21,250,000 per year. Based on a meeting of eight of the firms, and subsequent telephone calls and reviews of the draft of this statement, a consensus of all of the undersigned firms was achieved.

The firms in this group may be further described as follows:

1. Not affiliated with each other in any way.
2. Directly compete with each other.
3. Clients are mainly owner-managed commercial enterprizes.
4. The SEC clients of each firm number zero to a few.
5. Directly and frequently compete with Big 8 CPA firms.

One might logically guess that these firms would favor the proscription of MAS work for SEC companies by CPA firms, so that this MAS work might move from Big 8 CPA firms to local CPA firms. On the contrary, however, our group unanimously and strongly opposes any limitations whatsoever on the performance of MAS services by CPA firms for their audit clients, whether SEC companies or not.

It is our opinion that restriction would be:

1. Expensive and hurtful to clients.
2. Extremely damaging for local CPA firms.
3. Of no benefit at all to the general public.

THE FORGOTTEN MAN - THE CLIENT

Several recent scandals have involved SEC companies that went bankrupt, bribed foreign officials or maintained political slush funds. Nets cast out to restrain possible future sharks will probably bring in the usual catch of minnows and assorted unexpected creatures. There is much concern for creditors and public stockholders. In the process, the client is forgotten and is caught in the net.

Typical clients of CPA firms in our group may be described as follows:

1. Owned and managed by a small (1-3 persons) group.
2. Annual sales of \$100,000 to \$50,000,000.
3. Lack of management depth.
4. Owner-managers each skilled in only one aspect of business management such as sales, production or engineering.
5. Owner-managers lack financial management skills.
6. Most have no financial officer (controller or treasurer). Indeed, many are fortunate to have a decent bookkeeper.

Our local CPA firms are likely to serve a client over many years. We become intimately familiar with the financial and business affairs of the client. This familiarity, gained in the audit and other work, allows us to perform efficiently and effectively when the client asks for help in tax planning, business planning, assistance in securing financing, installation of a cost accounting system, computer selection and installation, etc.

Our wide exposure to the financial and business affairs of dozens of clients further enables us to provide meaningful service at reasonable prices.

Very few clients of local CPA firms are capable of hiring a controller, treasurer, or even a bookkeeper without substantial assistance from the CPA firm. The CPA may:

- a) recognize the need to hire, b) define the position,
- c) describe the desired employee, d) interview candidates,
- e) make suggestions as to the best candidates, and f) help train the new person.

Many of our clients may not know a debit from a credit and would be helpless without the assistance of the regularly-employed CPA when hiring accounting or financial staff.

The experience and objectivity of the CPA firm are extremely beneficial to client firms interested in employee benefit plans. The CPA has no significant financial interest in whether a plan is adopted or in the nature of a plan. If a client is interested in a pension plan, for example, we might talk him out of it if the financial obligations would be burdensome. If such a plan is to be installed, it is likely that we would recommend employment of an outside consultant. In that event, our advice is usually required to aid and comfort the client.

Firms of our size are not likely to design and lay out a plant, but we surely help the clients to analyze and understand the financial effects on the business of plant expansion or rebuilding.

We would not be likely to design new products, but we do help the client to determine costs and sales prices and to project effects on the business.

We are not likely to perform insurance actuarial services, but every one of our clients needs our advice when considering proposals for life insurance policies.

Clients are already heavily burdened by complex reporting requirements that arose from a few SEC company scandals. Substantial additional burdens will result if the CPA's knowledge of the client cannot be reused in MAS work.

LOCAL CPA FIRMS ALSO TO SUFFER

We would be less than candid if we did not acknowledge our self-interest in this issue. It is our belief that the proscription of MAS work for SEC firms will:

1. Make non-SEC auditors appear to be second-class auditors,
2. Eventually result in restriction of MAS services to non-SEC clients, thus elimination part of our business (the part many of us find most satisfying), with the further result that:
 - a. It could be easier for clients to fool us because of our reduced contact with and understanding of the clients.
 - b. We will no longer be able to compete effectively against Big 8 firms.Most of our clients engage us because of the personal MAS service we are able to provide. Straight audit engagements usually go to the lowest bidder, and Big 8 firms almost invariably are significantly lower than we are.

The people who seem to object most to MAS services by CPAs are those with the least comprehension of this situation (see notice of this public hearing - page 6). We believe that it would be unfair to allow any group of professionals to be dictated to by those least qualified to make the required judgments. Must everything and everybody in this country be reduced to the least-common

denominator? Government seems to pursue this cause, but it is the duty of the private sector to resist.

NO BENEFIT TO THE GENERAL PUBLIC

It seems clear to us that the general public's best protection is the professionalism, ethics and unlimited personal liability of the CPA. It is our understanding that there is no known instance of a lack of audit independence resulting from MAS work.

Accuracy and completeness in audit work require that the auditor achieve a thorough understanding of the affairs of the clients. The performance of MAS work can only increase this understanding, thus increasing the reliability of published reports.

Banks constitute, by far, the largest group, outside of the owner-managers of clients, relying on financial statements of our clients. Many of these clients are recommended to us by these banks; to our knowledge, none of these banks have expressed concern as to our independence or the possible effect of MAS work on our independence. In many cases, banker recommendations arise because of essential MAS services that the banker and the client believe are necessary.

Of the approximately 71,000 AICPA members in public practice, about 44,000, or about 62%, are with local firms. Statistics covering over 334, 000 U.S. manufacturing firms show that 90% employ under 100 people. Out of more than 1,7 million U.S. retail establishments, only 66,000, or 3.9% have net worth over \$200,000. Out of over 463,000 U.S. wholesale companies, only 29,000, or 6%, have net worth over \$200,000. Out of over 898,000 U.S. service establishments, only 13,000, or 1.4%, have net worth over \$200,000.

We respectfully ask the Public Oversight Board to very carefully consider the effects that its actions will have on the small companies that constitute the large majority of companies in the U.S.

If you wish to ask me any questions, I will try to answer on behalf of the firms I represent.

We very much appreciate the opportunity to present our views, and we thank you for your time and attention.

MR. McCLOY: If you can approximate your answer, what are the chief MAS services that this group of accountants perform? Have you got any concept of the first three important services that they render?

MR. BERNSTEIN: I would say financial counseling of one type or another would be very important. Many of the business people really don't understand financing. They may not have a good picture of the effects of some of their actions on the future of the business or its ability to survive.

Almost any major action that a client wants to take is something that we are liable to become involved in, whether it is plant expansion, buying machinery, buying life insurance or taking on product lines. The financial impacts of these items.

This seems naturally to lead into actual counseling in business matters. I have never claimed that being a CPA automatically makes one a superbusinessman, but then, neither does anything else that I know of.

Our clients typically are in a relatively confined environment. They don't have a lot of contact with peers. They are concentrating on their day-to-day problems.

The advantage we bring them is contact with dozens and dozens of other business situations over years of experience and through the observation and collection of knowledge we are sort of brokering to them, the experience and knowledge that we have achieved with other clients.

MR. McCLOY: What is your professional staff? How much is it?

MR. BERNSTEIN: Our own firm?

MR. McCLOY: Yes.

MR. BERNSTEIN: Our firm, as a professional corporation, employs a total of 57 people.

PROFESSOR CARY: Professional?

MR. BERNSTEIN: No, there are seven clerical and the rest would be professionals or some might be called para-professionals.

MR. McCLOY: Do you do any industrial engineering. Do you do plant layouts?

MR. BERNSTEIN: No, I don't think that any of the firms in this group would actually lay out a plant or do industrial engineering. And with respect to such a plant, we would very likely be involved in projecting the financial effects and possibly even in assisting in the financing, but not in the physical layouts.

MR. McCLOY: You do the tax work?

MR. BERNSTEIN: Income tax work, yes, sir.

MR. McCLOY: Do you do executive recruiting?

MR. BERNSTEIN: Of financial people. I think it would be most uncommon for any of us to recruit a chief executive officer.

MR. McCLOY: Most of your chief executive officers are owners?

MR. BERNSTEIN: That is correct, sir.

MR. McCLOY: I don't know that I have any other questions.

MR. WOOD: Would your considerable involvement in financial problems and other general business advice to your clients mean that you would spend a number of days in consultation with your clients, greater than in a normal situation? Are you always available by phone to come out and sit down with them?

MR. BERNSTEIN: On reasonable notice or sometimes unreasonable notice. Yes, they call frequently. Either for telephone consultation or for meetings, and I think most of the firms in this group tend to see their clients on a regular basis. It is not just an annual service which is the certified audit.

MR. WOOD: That is what I was getting at.

MR. BERNSTEIN: It might be monthly, quarterly or semi-annually and/or other times as required.

MR. WOOD: I take it it is your feeling that although some of your associated firms who are associated with your statement do not have any SEC clients, and

accordingly, are not seeking membership in the SEC Section, that if MAS is proscribed for SEC audit firms, that it will trickle down in a short term to those of you who are not in the Section.

MR. BERNSTEIN: Yes, sir, that is exactly what we fear. I think there is a little bit more to it than that.

We really had two things that motivated us because in discussing it, the subject did come up: Well, hey, this might be a terrific thing. Now, if we can stop all those big guys from doing this, and some of the stuff that they can't do is going to fall in our laps, but we felt that it would trickle down to us, and we also generally felt that we prefer freedom and free enterprise as unfettered as possible, and that any sort of restrictions on economic activity even if it would benefit us financially was not something that it was in our hearts to favor.

MR. WOOD: We all agree with that.

MR. MATUSIAK: Mr. Bernstein, in your statement you said the Big Eight firms are invariably significantly lower than you are in "bidding" on auditing engagements.

It is widely believed that the charged time or hourly rates of the national firms are higher than the hourly rates for the smaller firms. How do you account for the fact that their audit fees are generally lower than yours?

MR. BERNSTEIN: Let me say first of all that there would have been at least one other firm that would have agreed and had their name on this but for that one point. They disagreed with our statement in that regard. However, we do not favor any kind of profusion or assistance in competing with Big Eight firms. We favor unfettered competition and free enterprise. We will just have to continue to take our chances in the market place.

My real opinion of that is that typically we would bump heads with them on an initial engagement.

Initial for somebody, and I think that they come in with a low price. I think they may actually reduce it below what otherwise it might have been, but that is not exclusive to them. It might be that somebody else might do that as well.

I also have the feeling that they go more for the over-all materiality, and I don't know whether any big eight firms are here, and if they disagree with me, I am sorry. I am not speaking from actual experience, for I have never worked at a big eight firm, but my impression is that they really do go for the overall material representations in the statements which, of course, we do, too, but we tend to get a little more nitty-gritty.

If the withheld tax payable account does not exactly equal the amount that they owe, if it will not be zeroed out by the next payment, then we would tend to try to get that straightened out.

We are much more involved in the day-to-day operations. It is keeping things straight for the clients' day-to-day work, and that may tend to raise our cost a bit. It is just my opinion.

PROFESSOR CARY: About what percentage of your work is in the MAS field vis-a-vis the auditing field?

MR. BERNSTEIN: I have found a surprising consistency among firms' percentages that I am familiar with. They seem to be very similar to ours.

At our firm certified audit work represents about 35% of our billable time, and we figure that what we call controllership, which is a mixture, it could be anywhere from write-up or bookkeeping work to counseling that is as esoteric as we get, is in the neighborhood of 50 to 60%.

PROFESSOR CARY: Thank you.

MR. WOOD: MAS is included in the controllership in the broad base?

MR. BERNSTEIN: It would be included in that. It is hard to distinguish in many cases. Since we have regular contact, we might be seeing the client every month and we might prepare his financial statement in the morning and sometime in the afternoon sit down and meet with the client for some period of time, and somewhere in there I think you ought to call it MAS work.

MR. MATUSIAK: How much of this 50 to 60% is from nonaudit clients?

MR. BERNSTEIN: Most. At least, speaking in our case, the number of audit clients is much less than the number of nonaudit clients. Most of our engagements are unaudited engagements, but the MAS services spread out over both unaudited and audited, so it would be roughly in proportion to the number of clients, or probably 2 or 3 or 4 times the amount of MAS work being done for nonaudit clients than for audit clients.

MR. WOOD: Do you seek to gain such confidence of your clients that they will make you the auditors as well as the supplier of services?

MR. BERNSTEIN: Yes, sir.

MR. GARRETT: When you say nonaudit clients, do you mean mostly clients that don't have audits by anybody?

MR. BERNSTEIN: That is correct.

MR. GARRETT: It isn't that someone else is doing the auditing? Or they don't need an audit.

MR. BERNSTEIN: Offhand, I cannot think of any clients of ours that also employ another CPA firm.

MR. WOOD: That is what I wanted to know.

MR. McCLOY: Your readers particularly are the banks, generally?

MR. BERNSTEIN: Yes, sir. Outside of the clients themselves, the great majority are the banks.

I did a study on that which I don't have with me, but if you are interested, I could get it for you. I

studied over 140 financial statements that we had issued as to where they went, and once you get beyond the client and the banks, there is only quite a small percentage left of other people that might see the statements. They are generally either sophisticated readers or insiders.

MR. GARRETT: Just as a matter of curiosity, is most of this that would be MAS work sort of day-to-day consulting, or a week-to-week, call up, or is some of it formal engagements for special studies of an MAS nature?

MR. BERNSTEIN: Most would be regular day-to-day or month-to-month, but there are a certain number of special engagements that we have, where we are asked to install a cost system, hire a controller, analyze possible plant expansion.

MR. GARRETT: That would be set up as a separate engagement?

MR. BERNSTEIN: It might be in many cases, or it might just tend to just flow along with the rest of the work.

MR. GARRETT: Do you have an MAS staff, division, group or something?

MR. BERNSTEIN: We have a small MAS staff. We have one person who devotes almost all his time to it, and is in charge of that and he draws on others in the firm as the engagement requires.

MR. GARRETT: What is the professional skill? He is a CPA?

MR. BERNSTEIN: He is not a CPA. He is a man that has actually been with us longer than any other staff person that we have, and we have found him to have extremely excellent business sense, street sense, even, if you will, and that his insights into business seem to be extremely good and a large number of our clients recognize that and value his counsel.

MR. GARRETT: I gather that these 11 firms that you speak of are not an association?

MR. BERNSTEIN: That is correct.

MR. GARRETT: They assembled for this purpose.

MR. BERNSTEIN: No, they got assembled by one of the gentlemen deciding that this would be a good idea for one of us to be here, and he called a bunch of his competitors. We had never met before. Some of the gentlemen I had never met before at all, and we had a luncheon. Apparently I opened my mouth more than the others, and here I am.

MR. WOOD: You got the job.

MR. BERNSTEIN: I think that was actually about two weeks ago, and it has been put together within the two-week period.

MR. GARRETT: Have you some idea of the extent to which the Executive Committee's proposals, that are the formal subject of this hearing, would affect your current practice if put into effect and applied to you.? Have you tried to determine what we are doing as it would fit under the accounting-and-auditing skill-related test and the participation of management test?

MR. BERNSTEIN: I think it would have two effects. Number one, it would reduce our practice somewhat. I don't think that the financial impact in our particular case would be catastrophic for us, although it would eliminate a good segment of our practice and a segment that is profitable.

MR. GARRETT: Is this the segment that is not accounting or auditing-skill related, or are you making a management decision?

MR. GARRETT: We have spent two days wondering where the line is whenever the subject comes up, so don't be surprised if you are not exactly certain.

MR. BERNSTEIN: If you find out, I hope you will tell me.

We get into things like trying to arbitrate

or help settle arguments between family members in family businesses.

MR. GARRETT: That is lawyers' work; you don't do that. (Laughter)

MR. BERNSTEIN: There is a fine line there, too. We have got two terrible wars going on now. We are just naturally drawn in because you know the people, and you know the numbers. Perhaps they trust you to get drawn in, but I think for me, at least, one of the worst aspects of not being able to do this kind of work, is that I like to do it. It is fun. That is why I am in this business, and if I get forced into a position where all I do is check and tick and do audits, then I am just not going to like my work any more.

MR. GARRETT: There are very few, if any, at least that have spoken these last two days, that would favor abolishing all MAS by all members. The questions have been whether there should be some tests of what they ought to be. A lot of agreement that independence is an important thing, but many saying that it is the only important thing.

One of the practical questions with respect to these proposals is how they would hit who, what they would do. It is not easy to determine if you can't figure out exactly how they work in particular circumstances, but I get the impression that any restrictions on MAS, you would oppose, and your group would oppose.

MR. BERNSTEIN: That is correct.

MR. GARRETT: But you wouldn't oppose the independence standard where you are engaging in the attest function?

MR. BERNSTEIN: No, I agree with independence 100%. I just don't agree that these activities impair it as long as we don't own a piece of the client and maybe some other criteria, but I think our unlimited personal liability is really where they have got us. No matter what we do for the client, we consider that, and the thing that has got to hurt your independence more than anything else has got to be the fees. I can't imagine anything that we could possibly do for a client that could compare in any way to it. Maybe the lack of independence that might come from wanting to retain the fees. You can't get away from fees, I hope.

MR. MANZONI: Do you think that getting involved in management decision would impair your independence?

MR. BERNSTEIN: Advising management when they have to make the decision. We don't make that.

MR. MANZONI: I understand. When you get closer away from advice toward actual involvement in the decision-making process, is that something that clearly impairs independence?

MR. BERNSTEIN: I don't think so. We consider ourselves extremely independent. We fight with the clients. We stand ready to lose them if they don't like what we are going to do, and it is always covering our assets and our unlimited liability that matters. What is the difference? How can you compare bending to a client, to getting sued, losing vast amounts of money and reputation to what you had built up over a career of work? That is where independence comes from, and we just

can't escape getting drawn into these family situations, these management decisions, and I have clients I have personally worked on for 25 years. I know their families. I know their business affairs from top to bottom, and when something comes up that they have to make a decision, it is hard for me to imagine that they are going to look in the phone book under management consultants.

MR. MANZONI: Are these kinds of clients the ones you typically might audit?

MR. BERNSTEIN: It could go either way. It depends. The length of the engagement has nothing to do with whether they are audit clients or not.

MR. MANZONI: What about the relationship? Does the relationship have anything to do with whether they are audit clients? The closeness of these families for a long time.

MR. BERNSTEIN: When I said closeness to families, I didn't really mean on a social or family basis. I meant that if I had worked for someone for 25 years, that I am aware that he has a father in a certain business or state of health and that he has children.

At least, in my case, I am not a very social person, I guess, and I am really not sociable with a lot of the clients, but I know their affairs extremely well, and I don't think that knowing their affairs well impairs our ability to be independent. Witness to that, I only point out, at least in our case, our firm has been in existence for over 50 years. It was started by my father. I have been in the firm for over 25 years. We have never been sued by anybody for anything any time.

MR. McCLOY: Somebody similarly situated to you testified that he was apt to know what all the marital relations were.

MR. BERNSTEIN: That would happen. When you go through somebody's checkbook, you never know what you are going to find out. (Laughter)

MR. McCLOY: Do you do a lot of advising on acquisitions, mergers, or doesn't that come up, or sales, I guess?

MR. BERNSTEIN: I couldn't say a lot because our clients do not often buy or sell, but when they do, I would say in the 100% of the cases that we will be involved with them in making the acquisition or making the sale. Absolutely.

MR. GARRETT: I think I understood you clearly, but let me be sure. A rule that, of the type being proposed, that left you out altogether or left out the largest part of your practice, you would still oppose?

MR. BERNSTEIN: Yes, sir.

MR. GARRETT: Because you don't want to tie your standards to the SEC firms for your type of firm. On the other hand, you don't think it would survive anyway.

MR. BERNSTEIN: We think it will spread to us, and we don't think that that is essential or desirable to maintain independence.

MR. GARRETT: Thank you very much. Are there any further questions?

That has been very helpful.

MR. BERNSTEIN: Thank you very much, gentlemen.

I have another set of our statement which is identical to the one that I sent to Mr. Matusiak except that it does have the list of firms that approved of this and it had some blanks filled in on the first page.

Thank you very much.

MR. GARRETT: If there is nothing further, would you like to declare the adjournment, Mr. Chairman?

MR. McCLOY: So declared.

MR. GARRETT: We are adjourned.

(The hearing adjourned at 3:30 o'clock.)